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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY,

Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

AMICUS CURIAE BRIEF ON BEHALF OF ST. LOUIS SAN FRANCISCO RAILWAY COMPANY; MISSOURI PACIFIC RAILROAD COMPANY, AND GULF, MOBILE & OHIO RAILWAY COMPANY

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Pursuant to Rule 42 of the Supreme Court's Rules and the consent (Appendix A and B) of each of the primary parties, this amicus brief is hereby filed in support of the position, relating to debt discount, as set forth and upheld in the decision of the United States Court of Appeals for the Tenth Circuit in *National Alfalfa Dehydrating and Milling Company v. Commissioner*, 472

F.2d 796 (1973). Each of the above-listed amici curiae, St. Louis San Francisco Railway Company (Frisco), Missouri Pacific Railroad Company (Mo. Pac.) and Gulf, Mobile & Ohio Railway Company (GM&O), have quite similar debt discount issues to that involved in the *National Alfalfa* case pending in various jurisdictions, including this Court.[1]

OPINIONS BELOW

The opinions below, which are submitted for consideration, may be found in the Appendix as follows:

(1) *National Alfalfa Dehydrating and Milling Company v. Commissioner*, (CA-10, 1973), 472 F.2d 796 (Appendix C).

(2) *St. Louis San Francisco Railway Company v. United States* (Ct. Cls., 1971), 444 F.2d 1102, cert. denied 405 U.S. 1017,(Appendix D).

(3) *Missouri Pacific Railroad Company v. United States* (Ct. Cls., 1970), 427 F.2d 727, cert. denied 402 U.S. 904, (Appendix E).

(4) *Gulf, Mobile & Ohio Railway Company v. United States* (U.S. Dist. Ct., Ala., 1972), 339 F.Supp. 489, and U.S. Dist. Ct., Ala., 31 AFTR2d 73-348 decided 1/12/73 (Appendix F and G).

JURISDICTION

The petition was filed on June 25, 1973 and certiorari was granted on October 9, 1973. The jurisdiction of this Court rests on 28 U.S.C. 1255(1).

[1] A petition for certiorari (Docket No. 72-1245) was filed with this Court on March 12, 1973, in *St. Louis San Francisco Railway Company v. United States*, 470 F.2d 523. That petition remains pending.

QUESTIONS PRESENTED

1. When a corporation issues debentures in exchange for its preferred stock having a market value less than the face amount of the debentures, does the difference between the market value of the preferred stock and the face amount of the debentures constitute additional interest amortizable over the life of the debentures.

2. When a corporation issues new bonds in exchange for its old bonds having a market value less than the face amount of the new bonds, does the difference between the market value of the old bonds and the face amount of the new bonds constitute additional interest amortizable over the life of the new bonds.

3. Whether any portion of the amortizable debt discount and expense attributable to outstanding debt securities may be carried over and amortized over the life of the new debt securities issued in exchange therefor in a reorganization of a corporation involving the issuance of new stock and debt securities for the previously outstanding debt securities.

STATUTES INVOLVED

The statutory provisions involved are Section 163 of the Internal Revenue Code of 1954 (26 U.S.C. Section 163) and Income Tax Regulations 1.163-3 promulgated by the United States Treasury. These sections are printed in Appendix H and I.

STATEMENT

The facts pertaining to each of the amici, which are parties to this brief, are closely related to the facts of the present respondent (Alfalfa) in this proceeding and are set forth separately below:

A. St. Louis San Francisco Railway Company

Amicus (Frisco) is a corporation organized and existing under the laws of the State of Missouri, and has its principal offices in St. Louis. At all times here pertinent, Frisco was engaged in operating as a common carrier by rail in interstate commerce and employed the accrual method of accounting.

1. In 1956, Frisco exchanged Series A, 5% Income Debentures bearing a maturity date of January 1, 2006, plus cash and common stock for a part of its outstanding Series A, 5% Preferred Stocks, issued in its 1947 reorganization. The Internal Revenue Service ruled that this exchange was a reorganization under Section 368(a)(1)(E) of the Internal Revenue Code of 1954. It also ruled that gain, if any, was recognizable to the exchanging preferred stockholders measured by the excess of the aggregate fair market value of the securities and cash received over the tax basis of the preferred stock surrendered. For each $100 par value share of preferred stock surrendered, the holders of the preferred stock received a $100 maturity value Series A Debenture and one quarter share of common stock. They also received $5.00 cash for the dividends on the preferred stock which would have been due at the next dividend payment date had the preferred stockholder not surrendered his stock. In the aggregate, Frisco issued new debentures having a face value of $33,129,000, 82,823 shares of no par value common stock and cash in exchange for 331,290 shares preferred stock, a total par value of $33,129,000 but a market value, based upon New York Stock Exchange quotations, of $22,908,148.35. Frisco contends that, based upon the legal principles enunciated by the Tenth Circuit Court of Appeals in *National Alfalfa*, it should be entitled to amortize as additional interest the difference between the maturity value ($33,129,000) of new de-

bentures issued and the fair market value of the preferred stock ($22,908,148.35) received in exchange for the new debentures as debt discount, and in any event, that it sustained debt discount upon the exchange to the extent of the value of the common stock and cash given up in the exchange.

The Court below (Court of Claims) held in the *Frisco* case, supra, that Frisco was not entitled to amortize the difference between the maturity value of the new debt securities and the fair market value of the preferred stock nor did Frisco sustain debt discount to the extent of the value of the common stock given up in the exchange. In support of its decision in the Frisco case, the lower court relied upon its prior decisions in *Erie Lackawanna Railroad Company v. United States*, 422 F.2d 425 (Ct. Cl., 1970), and *Missouri Pacific Railroad v. United States*, 427 F.2d 727 (Ct. Cl., 1970), modified on reconsideration, 433 F.2d 1324 (1970), cert. denied, 402 U.S. 944 (1971).

2. Frisco was reorganized, effective January 1, 1947, pursuant to a plan of reorganization approved by the Inter-state Commerce Commission and the Federal District Court having jurisdiction over Frisco's trusteeship under Section 77 of the Federal Bankruptcy Act, 11 U.S.C. Section 205 (1964). Under the reorganization plan, the outstanding common and preferred stock and the claims of unsecured creditors were eliminated as worthless and the holders of the several classes of long-term indebtedness and the bank creditors received new bonds, preferred stock, common stock and cash. As part of such plan, Frisco issued new 4% First Mortgage Bonds and 4½% Second Mortgage Bonds having an aggregate maturity value of $120,935,000 but a market value, established by the New York Stock Exchange quotation, totaling $91,866,411 in exchange for the

outstanding old secured debt. Frisco contends that it is entitled to amortize the difference of $29,068,589 between the maturity value of the new bonds and the fair market value of the old bonds as additional interest over the life of the new securities.

The Court below held that the difference between the maturity value of the new bonds and the fair market value of the old bonds did not constitute additional interest amortizable over the life of the new bonds "because the maturity value of the new debt did not exceed the maturity value of the old debt". The Court cited its *Erie Lackawanna* and *Missouri Pacific* decisions, supra, in support of its opinion.

3. In 1947, Frisco underwent a reorganization pursuant to Section 77 of the Bankruptcy Act. Under the approval plan as finally adopted by the ICC and the Courts, Frisco exchanged new bonds, new stock and cash for old debt securities, stock, bank loans and accrued interest. At the time of such reorganization (January 1, 1947), Frisco had an old extant debt on which there remained unamortized debt discount and issuance expense as follows:

Debt Security	Unamortized Debt Discount And Expense
Prior Lien 4% Bonds, Series A	$ 224,903.00
Prior Lien 5% Bonds, Series B	2,214.00
Consolidated 4½% Bonds, Series A	4,182,322.00
Consolidated 6% Bonds, Series B	8.33
Total	$ 4,409,447.33

All of the above-listed debt had been issued by Frisco between 1916 and 1947 for cash. For example, in 1928, the ICC, by Finance Docket No. 6798-1928, 138 ICC 505, granted Frisco authority to sell $108,000,000 of its

Consolidated 4½% Bonds, Series A, at a discounted price of 94½; and such sale was duly consummated, with the result that Frisco suffered actual cash discount in excess of $4,000,000.

In the course of the audit of Frisco's income tax returns for the years immediately following its 1947 reorganization, the Internal Revenue Service allocated the pre-reorganization unamortized discount to interest, the new common stock and debt securities. Such allocation was made by determining the percentage of new bonds issued in exchange for interest, common stock, preferred stock and the old debt securities and applying the percentages to the total unamortized discount. The amounts allocated to the new debt securities were as follows:

New Debt Securities	Old Unamortized Discount and Expense Allocated
4% First Mortgage Bonds	$ 969,605.41
4½% Second Mortgage Bonds	684,005.41
Total	$1,653,610.82

The Internal Revenue Service allowed Frisco's deductions for amortization of the allocated carryover discount for the years 1947 through 1965. The balance of such carryover discount, deemed to be attributable to interest and the stock in the 1947 reorganization, was "washed out" and no deductions have ever been claimed or allowed with respect thereto.

In the Court below, the Government asserted as an offset that the amortization deduction for the years 1953 through 1962 were improperly allowed and the Court sustained the Government's contention on the ground that the issue was governed by its decision in *Chicago, Milwaukee, St. Paul and Pacific Railroad v. United States*, 404 F.2d 960 (1968).

B. Missouri Pacific Railroad Company

Missouri Pacific Railroad Company (MP), is a corporation organized and existing under the laws of the State of Missouri and has its principal offices in St. Louis. At all times here pertinent, MP was engaged in operating a common carrier by rail in interstate commerce and employed the accrual method of accounting.

MP, along with its subsidiaries, was organized, effective March 1, 1956, pursuant to a plan of reorganization approved by the Interstate Commerce Commission and the Federal District Court having jurisdiction over MP's trusteeship under Section 77 of the Federal Bankruptcy Act, 11 U.S.C. Section 205 (1964). Under this reorganization plan, MP issued its new Collateral Trust Notes, First Mortgage 4¼% Bonds, Series A and B, 5% 90-Year Debentures and stock in exchange for its previously outstanding debt securities and stock and securities of its subsidiaries, which were merged with MP as a part of said reorganization proceedings. In accordance with said plan and consummation order, upon consummation of the reorganization, the old outstanding debt and stock were retired and cancelled.

The aggregate maturity value of the new Collateral Trust Notes, First Mortgage 4¼% Bonds, Series B and C, General Mortgage Income 4¾% Bonds, Series A and B, and the 5% 90-Year Debentures issued under the reorganization plan was $529,117,141.00. The fair market value of the old securities and stock of MP and its subsidiaries, for which the new securities were issued, was $452,151,252.00 on the date of exchange. The difference between the maturity value of the new securities and the fair market value of the old was $76,965,889.00. MP amortized this difference over the life of the new securities and claimed debt discount (additional interest)

deduction of $1,027,372.00 for 1957, $1,023,325.00 for 1958, $1,018,760.00 for 1959, $1,019,453.00 for 1960 and $905,650.00 for 1961. The Court of Claims denied such deductions.

C. Gulf, Mobile and Ohio Railroad Company

Amicus GM&O at all times here pertinent was a corporation organized and existing under the laws of the State of Mississippi and was engaged in operating as a common carrier by rail in interstate commerce and employed the accrual method of accounting.

1. In 1957, the GM&O applied for and received permission from the Interstate Commerce Commission (ICC) to issue 5% income debentures, Series A, due December 1, 2056, in the principal amount not to exceed $28,343,800 in exchange for up to 283,438¼ shares of its issued and outstanding preferred stock, without par value, $5.00 series, having a stated value of $100 per share. Pursuant to that authority GM&O during the period December 31, 1957, through December 31, 1962, issued a total of 187,116 income debentures in exchange for a like number of shares of preferred stock.

The exchange was a taxable exchange to those holders of the preferred stock who exchanged their shares for the income debentures. During the exchange offer, GM&O's preferred stock was listed on the New York Stock Exchange. GM&O claimed a deduction for amortizable debt discount arising from the exchange of its income debentures for its preferred stock by taking the total principal amount ($18,711,600) of the income debentures issued and subtracting therefrom the total fair market value ($11,869,092.44) of the preferred stock, received in exchange for the income debentures, as determined by the listing price on the New York Stock

Exchange. The resulting difference of $6,842,507.56 was claimed by the GM&O as the total discount arising from the exchange, which amount it claimed was amortizable over the 100 year life of the income debentures.

The Court below (District Court for the Southern District of Alabama) held that the exchange by the GM&O of its income debentures for its outstanding preferred stock was more than a reshuffling of its assets and that a very basic transformation had occurred in the capital structure of the corporation. A creditor, with full rights, had been substituted for what had previously been one with an owner interest in the company. The Court held that debt discount had occurred measured by the difference between the issue price originally received by the GM&O for the preferred stock and par value of the bonds, except if the fair market value of the preferred stock at the time of the exchange was greater than the issue price, then the debt discount would be the difference between the fair market value of the preferred stock and the par value of the bonds, provided, however, that no debt discount would exist if either the issue price or the fair market value of the preferred stock exceeds the par value of the bonds. The Court ordered a new hearing to determine the issue price of the preferred stock.

2. Upon rehearing, evidence was introduced that the preferred stock had been issued by the GM&O in 1940 as a result of a plan or reorganization arising out of the bankruptcy reorganization of the Mobile and Ohio Railroad Company. Under the plan of reorganization, the properties of the Gulf, Mobile and Northern Railroad Company (hereinafter the "GM&N") and the New Orleans Great Northern Railroad (hereinafter the "NOGN"), a leased railroad, and the bankrupt Mobile

and Ohio Railroad Company (hereinafter the "M&O") were unified into a new company. Pursuant to the plan, the GM&O was incorporated in November, 1938, and it issued bonds, preferred stock and common stock in exchange for the outstanding securities of the M&O which were allowed to participate in the reorganization, for the outstanding preferred and common stock of the GM&N and for the outstanding common stock and income debentures of the NOGN. The Court below found that upon issuance of the preferred stock in 1940, the GM&O received substantially less than the then fair market value of the preferred stock on the dates of the exchange (approximately $70 per share during 1957 through 1962).

3. In determining the fair market value of the preferred stock issued by the GM&O in exchange for its income debentures during 1957 through 1962, the Court below refused to look solely to the market prices of GM&O's preferred stock as reflected on the New York Stock Exchange. Expert testimony was introduced concerning the fair market value of the stock and the Court below, as the trier of facts, determined that the fair market value of the preferred stock to the GM&O was $80.00 per share. In determining this value, the Court below gave consideration to the fact that as a result of the exchange GM&O acquired an income tax deduction for the interest it paid on the income debentures while no deduction was allowed for the dividends paid on the preferred stock.

SUMMARY OF ARGUMENT

(A)

It is now universally accepted that debt discount is additional interest paid or to be paid for the borrowing of

funds. In all the cases involved in this proceeding, the courts have treated debt discount as additional interest, paid over and above stated interest, for the use or forebearance of money (*Deputy v. DuPont*, 308 U.S. 488, 498 (1940); *United States v. Midland-Ross Corp.*, 381 U.S. 54). Petitioner, in its brief (p. 6-7) to this Court in *National Alfalfa*, supra, states that ". . . the Court has been explicit in recognizing discount as serving the function of interest, and the current Regulations treat it under Section 163, which allows a deduction for interest paid or accrued".

(B)

Debt discount, being interest, constitutes one of the costs of acquiring and retaining the use of borrowed funds. It follows that what a debtor does with the assets acquired by the issuance of debt and what its adjusted tax basis, for such assets so acquired, may be for gain or loss purposes have completely independent tax consequences from any discount that may be sustained by reason of the issuance of debt. Gain or loss under the Internal Revenue Code are terms of art directly related to tax basis of property and the disposition thereof but have no relationship with debt discount or interest expense incurred for the use of borrowed funds.

(C)

Once debt discount has been appropriately characterized as interest, it is imperative that the proper method of measuring debt discount be prescribed. Contrary to the decisions of the Court of Claims, and correctly so, the United States Court of Appeals for the Tenth Circuit, in *National Alfalfa*, supra, held that debt discount represented the difference between the face amount of the

debt issued and the market value of the preferred stock as of the time of its exchange for such debt. The position adopted by that court is wholly consistent with long-established Internal Revenue Service rules and court decisions for determining the value of securities (cf., Interal Revenue Code, 26 U.S.C. Section 2031 (1964), Treas. Regs., Section 20.2031-2(b) and 25.2512-2(b)).

(D)

Petitioner, in its *National Alfalfa* brief, at pages 8 and 9, contends that no bond discount could arise where a $50 debenture is issued in exchange for $50 par value preferred stock on the basis of arithmetical equivalence. That contention completely ignors the realistic pressures of the money market at the time debt securities are issued. The payment of a discount or the issuance of securities in a face amount or maturity value greater than the securities received in exchange is an absolute necessity and inducement where the interest rate called for in the bond is less than the going rate for the use of money in effect at the time of issuance.

Petitioner at page 9 of its brief states that it seeks reversal of the Circuit Court of Appeals decision in *National Alfalfa* on the broader ground that the substitution of one security for another does not produce deductible bond discount. The law, even in its present state, relating to debt discount does not support petitioner's proposition. In addition, that proposal is contrary to the intent and purpose of the amendment to Section 1232(b)(2) of the 1954 Internal Revenue Code, enacted by Congress as Section 413 of the Tax Reform Act of 1969, which provides that debt discount can arise where debt is issued for stock or other property and that such discount is measured by the difference between the

maturity value of the debt and the fair market value of the property received in exchange therefor.

Under the circumstances of this proceeding, the Court of Appeals' decision in *National Alfalfa* should be affirmed and the Court of Claims' decision relating to debt discount should be reversed as erroneous and not in accord with the law.

ARGUMENT

I.

RESPONDENT, NATIONAL ALFALFA, AS WELL AS EACH AMICUS, SUSTAINED AMORTIZABLE DEBT DISCOUNT WHEN THEIR DEBT SECURITIES WERE EXCHANGED FOR DEBT AND/OR STOCK.

In the case of National Alfalfa, and in the situation relating to each of the amicus-taxpayers in this proceeding, debt securities were issued in exchange for old debt and/or stock where the fair market value of the old securities and/or stock was less than the maturity value of the new debt securities issued in exchange therefor.

Section 163 of the 1954 Internal Revenue Code provides:

> (a) General Rule. There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Income Tax Regulations, Section 1.163-3 provides:

> Sec. 1.163. Deduction for bond discount.
>
> (a) Discount upon issuance. (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds.* * *

It is now a well-established principle that debt discount is additional interest paid or accrued for the use of

borrowed capital, or compensation for the use or forebearance of money (*Deputy v. DuPont*, 308 U.S. 488, 498 (1940); *Helvering v. Union Pacific Company*, 293 U.S. 282, 286; *Dodge Bros. v. Commissioner*, 118 F.2d 95, 103 (CA-4, 1941); *Court Holding Company*, 2 TC 531 (1943), 143 F.2d 823 (CA-5, 1944), rev'd on other grounds, 324 U.S. 331 (1945); *Central Station Signals, Inc.*, 10 T.C. 1015 (1948), aff'd. per curiam, 174 F.2d 479 (CA-2, 1949). The liability for the payment of such additional interest is created when the maturity value of the debt securities issued exceeds the proceeds or consideration received upon issuance of such debt obligations. Where debt discount occurs, as in the case of all the present parties, it must be amortized by an accrual basis obligor ratably over the life of the debt to which it is attributable. (*Helvering v. Union Pacific Company*, supra, Income Tax Regs., Section 1.163-3, 1954 Code).

In its brief in *National Alfalfa*, page 7, the Government argued that in order for discount to exist, there must be an outlay, or an obligation to make an outlay, in excess of the amount of borrowed capital. The question is not whether the taxpayers here involved have obtained new capital or retained their capital borrowings at the old level, but whether such corporations have obligated themselves, because of money market conditions or other reasons, to pay additional interest for the use of their borrowed capital. Each of such corporations has obligated itself to pay additional interest over the term of the debt to effectuate the exchange. A taxpayer has the unqualified right under the Federal Income Tax statutes and regulations to deduct from his gross income in a tax year interest actually paid or accrued in such year in a bona fide transaction (*National Alfalfa*, supra).

Because of the divergent views, reasoning and confusion relating to the debt discount problem, expressed

by the lower courts in recent cases, i.e., *National Alfalfa*, supra, *Atchison, Topeka and Santa Fe Railroad v. United States*, 433 F.2d 147 (CA-10, 1971), *Cities Service Company v. United States*, 316 F.Supp. 61 (S.D.N.Y., 1970), *Claussen's, Inc. v. United States*, Civil No. 1350 (S.D.Ga., 7/29/71, reversed and remanded, 469 F.2d 340 (CA-5, 1972), *Erie Lackawanna Railroad Co. v. United States*, 422 F.2d 425 (Ct. Cl.), *Missouri Pacific Railroad Co. v. United States*, 427 F.2d 727 (Ct. Cl.), modified, 433 F.2d 1324, cert. den. 402 U.S. 944, there is an overwhelming need for this Court to allay the confusion and resolve the conflicts between the various circuits. The problem is national in scope and requires authoritative resolution by this Court.

Over the years and particularly within the last four decades, a large number of railroads have had to undergo reorganization in bankruptcy. Indeed, the extent of this phenomenon and the national concern involved finds recognition in the special provisions which have been added to the Bankruptcy Act (11 U.S.C. Section 205) to handle this class of economically distressed business corporations. As a part of these reorganizations, new securities issued in exchange for the older outstanding classes of securities, with discount or additional interest being the inducement to the holders of the old securities to agree to the plan. The issuance of debt at sharp discounts has long been present in railroad reorganizations and the tax impact of denying the deduction to the reorganized road during precarious post-reorganization periods defeats the purpose and hope of the reorganization.

The courts below, in a number of recent cases, have confused debt discount with loss. As will be discussed below, there are no basis problems involved in the present case. What is involved here is the additional cost National Alfalfa and each of the amici in their respective cases had

to incur in addition to the interest specified in the obligation issued by each of the respective parties. The additional cost was interest deductible over the life of the obligation (*National Alfalfa*, supra). The substance of the National Alfalfa transaction, like that of each amicus, was no different than the borrowing of money by issuing bonds at a discount followed by the purchase of the old debt or old preferred stock at their respective fair market values. The courts below agree that in that situation there is discount but they refuse to see it where the new obligations are issued directly for the old, with the first step of issuing the bonds for cash being omitted. In treating the bonds and preferred stock of the issuer as a special class of property calling for special treatment, the courts below have created an arbitrary distinction beyond all legislative sanction.

II.

AMORTIZABLE DEBT DISCOUNT HAS NO RELATIONSHIP WITH "LOSS" UNDER THE PROVISIONS OF THE INTERNAL REVENUE CODE.

At pages 12-13 of its brief, in *National Alfalfa*, petitioner-Government argues that until the decision of the Court of Appeals for the Tenth Circuit, it had been generally assumed that whether discount was characterized as an interest expense or as a loss was of no practical significance because under either terminology, a deduction for bond discount serves to reduce the tax liability of the issuing corporation. Petitioner's argument continues that, however, in order for bond discount to arise, there must be an outlay, or an obligation to make an outlay, in excess of the original capital borrowed. It appears that petitioner is urging this Court to adopt petitioner's untenable and outdated theory that where

debt obligations are issued by a corporation in exchange for its old, outstanding debt or stock, such transaction represents only a recapitalization, controlled only by the reorganization and gain or loss provisions of the Code and that Code Section 163, relating to interest paid or accrued, must be ignored. Petitioner's assessment of the exchange is erroneous.

The question here presented is not whether the exchange in each of the present cases was taxable or non-taxable or what the basis is of the property exchanged under the Section 368 reorganization provisions of the Code, but, instead, whether National Alfalfa and each amicus sustained debt discount upon the issuance of debt obligations to acquire their extant debt or stock. If debt discount or an obligation to pay additional interest was thus incurred, National Alfalfa and each amicus would be entitled to debt discount amortization deductions under Section 163 of the Code, which provides that all interest paid or accrued in a taxable year on indebtedness constitutes a deductible expense (Section 163(a), 1954 Code). The tax basis of the stock or other property acquired by the respondent or amicus upon issuance of their new debt is quite irrelevant to the question of whether amortizable debt discount was incurred. Only the fair market value of the old debt or stock acquired in relation to the new debt's maturity value would be pertinent.

A concrete example of the operation of debt discount up to and including the redemption of a security will help dispel the aura of confusion created by petitioner's erroneous reference to debt discount as "loss" or an "outlay, or an obligation to make an outlay, in excess of the original borrowed capital."

Assume that a taxpayer issued its new 10 year, 5%-$100 bond for an old bond of similar maturity value

having a fair market value of $90. Taxpayer has sustained debt discount of $10, measured by the difference between the $100 maturity value of the new bond and the $90 market value of the old bond at the time of exchange. When the new bond is paid off or redeemed at maturity (10 years from issuance), taxpayer will pay out the principal amount of $100 and will have paid stated interest of 5% per year for 10 years, for which interest expense he will have received a tax deduction. Also taxpayer would have been entitled to and would have taken a tax deduction for the amortizable debt discount (additional interest) at the rate of $1.00 per year. Such accounting does not encompass any gain or loss situation as amortization of such interest expense has no bearing on tax basis (Income Tax Regs., Section 1.1032-1).

The only manner in which gain or loss and tax basis would enter into this hypothetical situation would be in connection with a sale or other disposition of the bond by the bondholder before maturity. If the bondholder had a tax basis of $90 in such bond and sold it for more or less than $90, gain or loss to such bondholder would be based upon the difference between the $90 tax basis and the amount realized upon such sale. That transaction would not affect a taxpayer's liability to pay its obligation for debt discount based upon the maturity value of the bond as well as the 5% stated interest. If the debtor redeems its $100 maturity value bond at the end of the fifth year for $90, the $5.00 of amortized discount will constitute gross income to the debtor under Section 61(a)(12) of the Code. If the debtor had received property having a fair market value of $90 for its $100 bond its basis for the property would be $90 and would remain completely unaffected by the debtor's amortization of the $10 of discount on the debt's retirement prior to maturity at a $5 gain by the debtor. The tax

consequences[2] of the issuance of debt at a discount and the ultimate retirement are quite separate and distinct from the tax consequence resulting from the acquisition, retention and disposition by the debtor of the consideration received upon such debt's issuance.

Because of petitioner's several confusing references to and the characterization of the debt discount involved in the subject cases, it is imperative to bear in mind that gain, loss or tax basis transactions when dealing with property dispositions are covered by the tax basis provisions of the Code (Section 1031, et seq.). Discount on the issuance of debt is treated separately under the bond discount provisions (Section 163).

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[2] The Commissioner of Internal Revenue and certain lower courts have taken the position that respondent and each amicus are not entitled to amortize and deduct the debt discount (for example $1,000,000) at which their debt securities were issued. IRS and those courts have also taken the position that there should be included in taxable income the difference between the par or face value and purchase price whenever the taxpayers reacquire any of their debt obligations. The absurdity of such determinations is made apparent if we assume that a taxpayer, on one day, issued its debentures for preferred stock with a value of $1,000,000 less than the principal amount of the debentures and then, on the next day, reacquired the debentures for exactly the same price at which the preferred stock was selling on the previous day. Applying the erroneous determinations of the IRS, taxpayer would be in receipt of taxable income in the amount of $1,000,000 because it acquired its preferred stock by issuance of debentures retired one day after issuance rather than by purchasing its stock for cash. This totally illogical result is not possible because taxpayer's debentures were, in fact and in law, issued at a discount of $1,000,000 and the gain or loss upon reacquisition of such debentures must be determined by reference to their issue price (the fair market value of the preferred stock received) with the result that no "make believe" or phantom income is generated by the transaction.

III.

WHERE NEW DEBT IS ISSUED IN EXCHANGE FOR OLD DEBT OR STOCK, FAIR MARKET VALUE OF THE OLD DEBT OR STOCK RECEIVED IS THE PROPER BASIS FOR MEASURING DEBT DISCOUNT.

When new debt is issued by a corporation having a maturity value in excess of the value of the old securities or stock received in exchange therefor, the question arises as to what is the measurement of the debt discount incurred. What is the proper method to be used for determining the amount of debt discount? On this point, except for a few sound and well-reasoned discussions,[3] the law pronounced by the lower courts borders on the chaotic.

In *National Alfalfa*, as in each of the amicus cases, the measure of debt discount incurred and claimed was established by comparing the maturity value of the new debt issued with the fair market value, based upon New York Stock Exchange quotations, of the old debt or stock received in exchange. The difference between such maturity value and the fair market value represented debt discount as claimed by the taxpayer.

Fundamentally "fair market value" is defined as the price at which property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell. In each case in question, taxpayer's old debt securities and stock had a public market and were regularly traded on the Exchange.

[3](a) *National Alfalfa Dehydrating & Milling Co. v. Commissioner*, 472 F.2d 796 (CA-10, 1973).

(b) *American Smelting & Refining Co. v. United States*, 130 F.2d 883 (CA-3).

(c) *Nassau Lens Co. v. Commissioner*, 308 F.2d 39 (CA-2).

Exchange prices and quotations reflect changes in corporate structures, operations and transactions and, therefore, generally represent a reliable price or fair market value for such corporate securities. Where debt securities and stock are listed and freely marketed in substantial amounts on a recognized exchange, the mean price between two trading prices on a given date is regarded as the fair market value for that date (*Leon R. Meyer et al. v. Commissioner*, 46 T.C. 65 (CA-8), 383 F.2d 883, aff'g., vac'g. and rem'g. T.C. on other grounds; *John J. Batterman*, 1 T.C.M. 667, aff'd. 142 F.2d 448).

On numerous occasions the Commissioner of Internal Revenue has taken the position, which has been upheld by the Courts, that the best and preferred basis for valuing stocks and bonds is reference to quoted market prices. That position has been maintained and sustained in every field of tax determination where value of stocks and securities was pertinent. For example, the United States District Court, S.D., New York, in *Southern Pacific Company v. United States*, 110 F.Supp. 637 (1953), involving the determination of liability for documentary stamp tax, adopting and quoting the Commissioner's position that use of the quoted market value was the proper basis for valuing stock, stated:

> In the case of stocks listed upon an exchange, the mean between the highest and lowest quoted selling price is considered as its market value.

That basis for determination of value of stocks and bonds is the same basis prescribed for Estate Tax and Gift Tax valuation purposes under the provisions of Section 2031 of the 1954 Code, Treasury Regs., Section 20.2031-2(b) and Section 25.2512-2(b).

In the present cases, respondent and each amicus established the market price of its securities and stock for

each exchange transaction and petitioner-Government admitted that the prices used by the former parties represented the New York Stock Exchange value. In *American Smelting & Refining Company*, supra, the Appellate Court opined that the taxpayer had carried its burden of proof and had sufficiently proved the value of what was received in exchange for its new debt securities for measuring debt discount by reference to the open market of the New York Stock Exchange.

The Appellate Court in *National Alfalfa*, supra, stated:

> It is firmly established by the adjudicated cases that where a corporation issues its bonds, including debenture bonds, which unconditionally oblige the corporation to pay the principal amount stated therein; together with interest thereon, at the times therein provided, and receives therefor the amount of the principal, less a discount, the amount of such discount is deductible as interest paid and should be amortized over the life of the bonds or debenture bonds.

As part and parcel of the Appellate Court's holding in *National Alfalfa*, the Court also adopted the measurement of the debt discount claimed on the basis of the difference between the maturity value of the debentures and the market value of the stock received in exchange for such debt securities.

IV.

RESPONDENT'S CONTENTIONS AND THEORIES WITH RESPECT TO DEBT DISCOUNT DO NOT MEET THE TESTS OF PREVAILING LEGAL PRINCIPLES.

In *National Alfalfa*, the Appellate Court stated that the two Court of Claims' decisions,[4] relied upon by petitioner, were followed by the Tax Court in its decision in the instant case, but that there is other respectable authority to the contrary. Moreover, the Court continued, the two Court of Claims' decisions and the decision (Tax Court) in the instant case, as has heretofore been shown, are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered. As indicated by the Appellate Court, the Court of Claims' misconception of the law applicable to debt discount is fatal to the persuasiveness of its decisions in the debt discount area.

In its arguments, at pages 8, 9 and 14 of its brief, petitioner contends no discount could arise from the issuance by National Alfalfa of its $50 debentures in exchange for its $50 preferred stock because of the arithmetical equivalence of the transaction. However, the long-established method of determining a debt discount transaction, as correctly reasoned and upheld by the Tenth Circuit Court of Appeals, clearly showed that by the most universal standard of security valuation, i.e., New York Stock Exchange value, arithmetical equivalence did not exist because the preferred stock at the

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[4] Even the Government, while subscribing to the results of such cases, finds fault with the Court's reasoning and labels them as misconceptions of the law.

time of exchange was valued at $33 per share, leaving debt discount of $17.

The method of measuring debt discount as adopted by the Appellate Court in *National Alfalfa*, supra, and as previously upheld in *American Smelting*, supra, i.e., debt discount is the difference between the maturity value of the new debt and the fair market value of the old debt or stock exchanged therefor, has the genuine quality of simplicity of application and lends symmetry to the entire transaction for tax and accounting purposes. Petitioner also contends that the exchange of securities in *National Alfalfa* did not have any major investment significance. Even the most cursory examination of the exchange, points up the fallacy of the proposition. That exchange like all the exchanges here involved, completely changed the relationship of the corporation and its lenders from that of an equity status to a creditor relatoinship, with the corporation now obligated to pay—not only the stated interest on the debt obligations, but also additional interest over the term of the new obligations. The significance of the investment change is quite apparent.

The analogy which petitioner draws (brief, p. 13), between the present case and *Old Mission Portland Cement Co. v. Helvering*, 293 U.S. 289, is inapposite. *Old Mission* is readily distinguishable from the present debt discount cases on a factual basis. In *Old Mission*, the Court concluded that because a subsidiary's bonds were held by another subsidiary, both of which joined in a consolidated return with their parent, the obligation to pay debt discount interest was eliminated as an intercompany transaction under the consolidated return statutes and regulations. In *National Alfalfa* and the case of each amicus the debt principal as well as the obligation to pay additional interest to third parties remained viable. In

Old Mission there was an obvious merger of the obligation to pay the principal and interest and the right to receive payment thereof into a single entity. The only fact the two types of cases had in common was the mere issuance of bonds.

Petitioner contends, commencing at page 19 of its brief (p. 19-26), that the exchange by National Alfalfa of its debt securities for its outstanding preferred stock was not a transaction analogous to the issuance of bonds for property because there was no acquisition of "property". Stock is property, but even if only minimal credence is allowed to petitioner's proposition, there is no real distinction in the treatment of discount arising upon the issuance of bonds for cash and discount arising upon the issuance of bonds for property, including stock of the issuer or others. Petitioner's proposition is certainly misdirected and wide of the mark because the Second, Third and Tenth Circuit Courts of Appeals have consistently held that, for purposes of Code Section 163 (relating to discount deductible as interest), it is immaterial whether bonds are issued for cash, for stock or for other property. According to the Tenth Circuit Court of Appeals, in *Atchison, Topeka and Santa Fe Railroad Co. v. United States*, 433 F.2d 147 (CA-10, 1971):

> . . . the regulations do not distinguish between bonds issued for cash and bonds issued for property. The regulation recognizes *sub silentio* the economic possibility that discount—that is, deferred interest—may be present when bonds are issued for property as well as for cash. Such discount is likely to arise when the stated rate of interest on the obligation is less than the rate demanded by the market.

The Second Circuit, in *Nassau Lens Company v. Commissioner*, 308 F.2d 39 (CA-2, 1972, rev'g. and rem'g., 35 T.C. 268 (1960), speaking through the then

Circuit Judge, Thurgood Marshall, rejected the proposition that the acquirer of property is not entitled to amortize debt discount arising with respect to obligations issued to obtain such property. That Court said:

> It may well be true that to a 'borrowing buyer' interest or discount payments seem part of the cost of the property. In reality, however, they are the cost of using the money which is needed to purchase the property, a cost not incurred by the buyer with ready cash. . . . The contention asserted (by the Commissioner) is merely that when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property, the tax laws will not recognize a charge for the use of money. We find no support for such assertion and reject it.

Even the Court of Claims, has held in *Missouri Pacific Railroad Company v. United States*, supra, that:

> . . . bond discount can arise where there is a difference between what is given up and what is received, and this can occur in connection with a corporate reorganization. The fact that there is a difference in value between bonds being issued and the securities being given up is enough to invoke the debt discount provisions. The ultimate result of the difference is that the corporation is obligating itself to pay a debt which is greater in value than that which it is receiving . . . consequently, any difference between (the original cost of the securities) and the maturity value of the bonds should be treated as a discount and amortized over the life of the bonds.

In addition, Congress, in its recent amendment of Section 1232(b)(2) of the 1954 Code, by enactment of Section 413 of the Tax Reform Act of 1969, did not distinguish or in any way separate stock from other

property in its treatment of debt discount. The Congress further provided that debt discount can arise where debt is issued for stock or other property and that such discount is measured by the difference between the maturity value of the debt and the fair market value of the property received in exchange therefor. The main congressional concern was the practical one of how is fair market value to be established. Hence, the property acquired for new debt must, in order for debt discount to arise under the new law, be traded on an organized exchange. Petitioner's contentions are wholly inconsistent with the statutory treatment of such discount.

Commencing at page 28 of its brief, petitioner contends that no discount could arise upon respondent's exchange of its $50 debentures for its outstanding preferred stock for which it had previously received $50. In support of that proposition, petitioner cites and discusses several recent decisions of the Court of Claims,[5] which the Tenth Circuit solidly rejected as being decided upon an erroneous premise.

In attempting to equate what was given with what was received from the standpoint of gain or loss, rather than focusing upon the interest expense aspect of the transaction, the Court of Claims decisions barred the finding of discount in any exchange of bonds for securities or other property by adopting the standard that what was received in exchange for bonds was equal to what was parted with in the bonds. By using the "value to the taxpayer" and the "equivalence" theory the Court of

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[5](a) *Erie Lackawanna Railroad Co. v. U.S.*, 422 F.2d 425.
(b) *Missouri Pacific Railroad Co. v. U.S.*, 427 F.2d 727, modified, 433 F.2d 1324, cert. den., 402 U.S. 944.
(c) *St. Louis San Francisco Ry. Co. v. U.S.*, 444 F.2d 1102, cert. den., 404 U.S. 1017.

Claims has erroneously introduced into an already confused area of law, a subjective standard which is incapable of measure by any known methods, thereby further compounding the problems of administering the tax law. It should be noted that if such a standard, with its dismissal of market value, were employed in the area of bargain sale, there could be no income in such situations, since it would have to be assumed that the purchaser received in value what he parted with in price regardless of the fact that similar property was being sold for several times that price in the open market.

National Alfalfa and each of the amici contend that the proper standard for measuring discount is the fair market value of what was received in exchange for the securities issued. The general rule for determining what is received in an exchange where property is concerned is its fair market value. This rule applies to bonds as well as other forms of property (*Gerard Trust Company v. United States*, 166 F.2d 773 (CA-3, 1948)). There is no reason why, in determining what amount of discount, if any, was involved, the fair market value of the old securities should not be used in computing such discount.

CONCLUSION

Based upon the foregoing propositions, the Tenth Circuit's decision in *National Alfalfa* should be affirmed and declared to be law with respect to the determination and measurement of debt discount.

Respectfully submitted,

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APPENDIX A

Office of the Solicitor General
Washington, D.C. 20530

November 21, 1973

Robert E. Simpson, Esquire
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Arlington, Virginia 22209

Re: Commissioner v. National Alfalfa Dehydrating and Milling Co., Supreme Court of the United States
Docket No. 73-9

Dear Mr. Simpson:

As requested in your letter of November 15, 1973, I consent to the filing by the St. Louis-San Francisco Railway Co., Missouri Pacific Railroad Co. and the Gulf, Mobile & Ohio Railroad Co., of a brief amicus curiae in support of the respondent in the above-captioned case.

Sincerely,

Robert H. Bork

Robert H. Bork
Solicitor General

APPENDIX B

LINDE THOMSON VAN DYKE FAIRCHILD & LANGWORTHY

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October 19, 1973

Mr. Robert E. Simpson
Molloy Legal Services, Inc.
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Arlington, Virginia 22209

Re: National Alfalfa Dehydrating and Milling Company v. Commissioner, Supreme Court, Docket No. 73-9
Participation as Amicus Curiae of St. Louis - San Francisco Railway Company

Dear Mr. Simpson:

We are in receipt of your letter dated October 11, 1973 wherein you request our consent to your intervention as an amicus curiae.

We would welcome your support in this case and would suggest that you take whatever actions you feel necessary in order to accomplish your entrance as an amicus curiae. We anticipate similar requests from Norton Simon, Inc. and Cities Service Company and similarly intend to consent to their presence in the case.

Norton Simon, Inc. is represented by Mr. Walter J. Rockler of Arnold & Porter, Washington, D.C. while Cities Service Company is represented by Mr. Thomas E. Tyre of Casey, Craig & Constance, 345 Park Avenue, New York, New York.

As you know, the Supreme Court Rules provide that oral argument may be granted to an amicus curiae only if the party being supported by the amicus gives up a portion or all of its time. On this point, we want you to know that we intend to use the full time allotted to us for oral argument.

If you have any additional questions or suggestions, please do not hesitate to contact us. You may also wish to contact Messrs.

Rockler and Tyre.

Very truly yours,

LINDE THOMSON VAN DYKE FAIRCHILD & LANGWORTHY

BY: Charles W. Hoes, Jr.

CWhH:lw
cc: Mr. Walter J. Rockler
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1229 19th Street, N.W.
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Mr. Thomas E. Tyre
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345 Park Avenue
New York, New York 10022

APPENDIX C

* * *

[¶ 9194] National Alfalfa Dehydrating and Milling Company, Petitioner-Appellant v. Commissioner of Internal Revenue, Respondent-Appellee.

U. S. Court of Appeals, 10th Circuit, No. 72-1125, 1/26/73. Reversing and remanding Tax Court, 57 TC 46, CCH Dec. 31,030.

[Code Secs. 61(a) and 163(a)]

Amortization: Bond issue discount: Exchange of debentures for outstanding preferred stock.—Amortizable bond discount resulted upon the issuance by the corporate taxpayer of debentures, each with a $50 maturity value, in exchange for its outstanding preferred stock with a fair market value per share of $33, made on a one-for-one basis. The court rejected the argument that no discount occurred since the $50 maturity value of the debentures issued was equal to the amount originally received upon issuance of each share of $50 par value preferred stock, and that no loss resulted. One dissent. Back references: ¶ 674.098 and 1423.20.

Charles White Hess, Ronald B. Stang, Linde, Thomson, Van Dyke, Fairchild & Langworthy, Floor Three, Columbia Union Bank Bldg., Kansas City, Mo., for petitioner-appellant. Ernest J. Brown, Scott P. Crampton, Assistant Attorney General, Meyer Rothwacks, Department of Justice, Washington, D. C. 20530, for respondent-appellee. Stuart S. Opotowsky, Alan D. Berlin, Walter J. Rockler, Julius M. Greisman, Richard L. Hubbard, Arnold & Porter, for N. Simon, amicus curiae.

Before PHILLIPS, HILL and HOLLOWAY, Circuit Judges.

PHILLIPS, Circuit Judge: National Alfalfa Dehydrating and Milling Company, hereinafter called National Alfalfa, was incorporated under the laws of Delaware on May 4, 1946. It was authorized to engage and did engage in the business of dehydrating and milling alfalfa.

The question presented in this case is whether National Alfalfa incurred amortizable and deductible bond issue discount, deductible as interest paid, when it issued its 18-year, five per cent, sinking fund debenture bonds, hereinafter referred to as debentures, each for the principal sum of $50, to be preferred stockholders in exchange for their preferred stock, on the basis of one $50 debenture for each share of preferred stock of the par value of $50, when at the date of the exchange the fair market value of the preferred stock was only $33 per share.

[Facts]

Prior to July 23, 1957, National Alfalfa had issued and outstanding 47,059 shares of $50 par value, five per cent, cumulative preferred stock in an aggregate par value amount of $2,352,950, and as of that date there was a dividend arrearage on each of such shares of $10. Such preferred shares were redeemable at the discretion of National Alfalfa, in whole or in part, at prices ranging from $53 per share for shares redeemed prior to December 1, 1949, to $51 per share for shares redeemed after December 1, 1955, plus accumulated and unpaid dividends down to the date of redemption.

When redeemed, such preferred shares could not be reissued by National Alfalfa, but had to be cancelled and retired by it.

National Alfalfa was required to set aside annually after September 1, 1948, 20 per cent of its consolidated net earnings,

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after a payment of accrued dividends on its outstanding preferred stock, for the purpose of redeeming preferred shares, as long as any were outstanding. However, such preferred shares could not be redeemed with funds in the sinking fund, nor purchased or acquired for value by National Alfalfa at any time when there were dividend arrearages thereon, unless consented to by the holders of 50 per cent of the preferred shares, or unless National Alfalfa notified all of its preferred shareholders of its desire to purchase such shares and invited them to tender offers.

On April 8, 1957, the Board of Directors of National Alfalfa adopted several resolutions which are set out in Note 1 hereto.[1]

The Board of Directors, by such resolutions, approved certain corporate actions, which, if approved by a two-thirds vote of each class of its shareholders and carried out, would constitute a reorganization of National Alfalfa within the meaning of 26 U. S. C. A. § 368(a)(1)(E). Such actions were:

1. The entering into of a trust indenture with Fidelity-Philadelphia Trust Company

[1] The text of the resolutions is as follows:

"RESOLVED, that the officers of the Company, be and they are hereby authorized to effectuate a reorganization of the Company by way of recapitalization, and

"RESOLVED, that the President or Vice-President and the Secretary or Assistant Secretary of the Company be and they are hereby authorized to enter into a trust indenture with Fidelity-Philadelphia Trust Company of Philadelphia, Pennsylvania, dated, as of July 1, 1957, pursuant to the terms of which there shall be issued $2,352,950.00 principal amount 5% Debentures, due July 1, 1975, which said bonds shall be issued in exchange for shares of the 5% Cumulative Preferred Stock on the basis of $50.00 principal amount of such debentures for each share of preferred stock and that this resolution, when ratified by the shareholders shall constitute authority for said issue, and

"RESOLVED, that the Company be authorized to issue warrants for the purchase of the common stock of the Company to each preferred shareholder participating in the exchange of his preferred stock for Debentures of the Company in the reorganization effective August 1, 1957, on the basis of one warrant for each share of Preferred Stock surrendered, said warrants to evidence the right to purchase one-half (½) share of common stock and said warrants to be exercisable to purchase only full shares of common stock of the Company at a price of $10.00 per share at any time from the date of issue until July 1, 1969 or so long as any debenture bonds remain outstanding, after which date warrants will become void, and

"RESOLVED, that the Company increase the par value of its shares from $1.00 to $3.00 and that the amount of $1,560,000.00 be transferred from Paid-In-Capital to the Capital Account in order to effectuate this resolution and reflect the increase in par value of the Common Stock, and

"RESOLVED, that the Articles of Incorporation of the Company be amended by changing Article FOURTH to read as follows:

"'The total number of shares of stock which the Corporation will have authority to issue is 1,000,000 shares of Common Stock of the par value of $3.00 per share.

The minimum amount of capital with which the Corporation will commence business will be $1,000.00.'

"1. Each share of Common stock shall be entitled to one vote per share in any matter requiring a vote of shareholders and each share shall be entitled, upon any liquidation, dissolution, or winding up of the affairs of the Corporation, whether voluntary or involuntary, to participant pro-rata in the assets available for distribution.

"2. No holder of shares of stock of the Corporation shall be entitled, as such, to subscribe to or purchase any additional shares of stock, whether now or hereafter authorized, or obligations convertible into any class or classes of stock, or shares of stock of any class convertible into any class or classes, or obligations, shares of stock or other securities carrying warrants or rights to subscribe to shares of stock of the Corporation of any class or classes, in any case whether now or hereafter authorized, but any and all shares of stocks, bonds, debentures or other securities or obligations, whether or not convertible into stock or carrying warrants or rights entitling the holders thereof to subscribe to stock may be issued, sold or disposed of from time to time by the Board of Directors to such persons, firms or corporations and for such consideration, so far as may be permitted by law, as it shall from time to time in its absolute discretion determine, without offering the same to the holders of shares of stock of the Corporation or any class then outstanding.

"3. The Company shall be entitled to issue warrants for the purchase of common stock on such terms as the Board of Directors may determine but such warrants when issued shall be binding on future actions of the Board of Directors and the terms thereof shall not be altered, amended or repealed without the consent of such warrant holders. AND

"RESOLVED, that this resolution and the reorganization and recapitulation contemplated hereby be submitted to a vote of the shareholders, and if adopted by the requisite number of shareholders, all rights and privileges of the 5% Cumulative Preferred Shares heretofore expressed or inherent in the ownership of said Preferred Stock shall cease and determine as of August 1, 1957, except such right to surrender the said shares of stock on the terms herein contained except as otherwise provided by law; and

"RESOLVED, that the officers of the Company be hereby authorized to submit the Plan of Reorganization to the Commissioner of Internal Revenue in an attempt to have the said Plan qualified as a tax free reorganization under the Internal Revenue Code of 1954; and

"RESOLVED, that the officers of the Company be hereby authorized to incur any and all necessary expenses to effectuate the Plan of Reorganization approved and adopted by this meeting of the Board of Directors."

of Philadelphia, Pennsylvania, as trustee, dated July 1, 1957, pursuant to the terms of which there would be issued $2,352,950 principal amount five per cent debentures, due July 1, 1975, and such debentures would be exchanged for all the shares of the outstanding cumulative preferred stock of National Alfalfa on the basis of one debenture for the principal amount of $50 for each share of such preferred stock of the par value of $50;

2. The issuance to each preferred stockholder participating in the exchange of his preferred stock for debentures of warrants effective August 1, 1957, for the purchase of common stock of National Alfalfa, on the basis of one warrant for each share of preferred stock exchanged, such warrants evidencing the right to purchase one-half share of common stock, but exercisable only for the purchase of full shares of such common stock at $10 per share at any time from the date of issue of such warrants to July 1, 1969; such warrants to be issued to and accepted by preferred stockholders participating in the exchange in lieu of the arrearage of cumulative dividends on their preferred stock;

3. (a) The amendment of the articles of incorporation of National Alfalfa, so as to provide for the issuance only of common stock;

(b) Increasing the number of shares of common stock from 763,000 to 1,000,000, and increasing the par value of the stock from $1 to $3.

The principal purpose of the reorganization was to enable National Alfalfa to extend easterly the territory in which it did business and effect a 50 per cent increase in its borrowing credit, which would be required by it for carrying the increased inventory which would result from such expansion. Such increase in the borrowing credit of National Alfalfa would be accomplished by issuing the five per cent debentures to the preferred stockholders in exchange for their preferred stock and the issuance to the preferred stockholders of the warrants to purchase common stock in discharge of the cumulative dividend arrearage.

The resolutions adopted by the Board of Directors of National Alfalfa were duly approved by the requisite number of votes of each class of stockholders at the regular annual meeting of National Alfalfa, held on July 23, 1957, and thereafter all of such resolutions were carried out.

National Alfalfa delivered to each of its preferred stockholders one $50, five per cent, debenture for each share of preferred stock held by such stockholders, and each of such stockholders delivered to National Alfalfa all of the shares of preferred stock held by him, and National Alfalfa retired such preferred stock.

In replying to a request for a ruling by Fidelity-Philadelphia Trust Company, the Treasury Department said in a letter to the Trust Company that no gain or loss would be recognized on the exchange of the $1 par value common stock for $3 par value common stock under the provisions of § 368 (a)(1)(E) of the Internal Revenue Code of 1954, but gain or loss would be recognized to the preferred stockholders on the exchange of their preferred stock for debenture bonds.

National Alfalfa also delivered to each of such preferred stockholders and each of them accepted warrants to purchase common stock of National Alfalfa, as set forth above, in satisfaction of the dividend arrearage on his preferred stock.

The indenture required that National Alfalfa should create a sinking fund for the retirement of the debentures by the following provision:

> "The Company (National Alfalfa) covenants and agrees that on or before the expiration of 90 days after the end of each fiscal year of the Company commencing with the fiscal year ending April 30, 1959, it will pay to the Trustee as and for a contingent sinking fund for the redemption of Debentures at the sinking fund redemption price of 100% of the principal amount of the Debentures so to be redeemed, together with accrued interest to the redemption date, a sum in lawful money of the United States of America sufficient to redeem $196,080 principal amount of said Debentures, provided that in any year when the Consolidated Net Income is insufficient to redeem $196,080 principal amount of said Debentures the amount required to be paid over to the Trustee shall be 100% of such Consolidated Net Income and the difference between that sum and $196,080 shall accumulate to be paid from the Consolidated Net Income of subsequent years and provided further that the Company must commence the accumulation of income for sinking fund purposes by setting aside 100% of Consolidated Net Income up to $196,080 in each year commencing with the year beginning May 1, 1957."

National Alfalfa has never been in default in the performance of anything required

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to be done by it by the terms of the debentures and the indenture.

On April 30, 1967, only 11,626 of the original debentures issued by National Alfalfa remained outstanding, and it had redeemed or otherwise repurchased and retired the other 35,433 debentures issued by it.

As shown by over-the-counter bids to purchase and offers to sell, the fair market value of each share of the preferred stock on July 23, 1957, was $33.

The debentures expressed unconditional and legally enforceable obligations on the part of National Alfalfa to pay the face amount thereof, with accrued interest, at the times and in the manner provided therein.

The indenture provided that:

> "This Indenture and the Debentures issued hereunder shall be subordinate only to current bank borrowings for inventory purposes which obligations mature by their original terms in less than twelve months and obligations of the Company (National Alfalfa) to suppliers of materials, services and labor incurred in the normal course of the Company's business and reasonably required in its operations, which obligations are due and payable when billed, and to any existing liens, encumbrances, mortgages, conditional sales agreements, or pledges, or any replacement, renewal, or extension thereof * * *"

and, unless consented to by the holders of at least 66⅔ per cent of the debentures outstanding when done, it should not be subordinated to any funded debt created, issued, assumed, or guaranteed by National Alfalfa or any subsidiary thereof, with certain enumerated exceptions.

The indenture contained many other provisions for the protection of the priority of the debentures and the rights of the debenture holders, but it would unduly lengthen this opinion to set them out in detail.

In its income tax returns for its fiscal years ending April 30, 1958, through April 30, 1967, National Alfalfa claimed deductions for interest paid by reason of the debenture discount alleged to have resulted from the difference between the fair market value of $33 of the preferred stock on July 23, 1957, and the face amount of the debentures then issued by it to the holders of its preferred stock. These deductions were computed on the basis of straight line amortization of the interest discount and the amortized amounts with respect to debentures retired in those years. The deductions in earlier years were included in losses carried over to the fiscal year ending April 30, 1967.

The Commissioner of Internal Revenue disallowed National Alfalfa's claimed deduction of $109,804 for interest paid, resulting from debenture discount for its fiscal year ending April 30, 1967, and also disallowed $321,657 of claimed deductions for interest paid, resulting from like discounts for the fiscal years ending April 30, 1958, through April 30, 1966, and determined deficiencies accordingly. Upon National Alfalfa's petition to the Tax Court to review the action of the Commissioner, the Tax Court affirmed the deficiencies asserted by the Commissioner. From the decision of the Tax Court, National Alfalfa has appealed to this court.

[*Discount Is Interest Not Loss*]

The decision of the Tax Court was based on the asserted proposition that where a corporation has issued its five per cent cumulative preferred stock at a stated par value (here, $50 per share) and thereafter issues its $50 debentures obligating it to pay the principal thereof at the times stated therein, and in the indenture under which the debentures were issued, together with interest at a stated percentage (here, five per cent) at the times stated in the debentures (here, semiannually), and exchanges such debentures for its preferred stock on the basis of one debenture for each share of preferred stock, although the market value of the preferred stock is less than its par value at the time of the exchange (here, $33 per share, or $17 less), thus giving the preferred shareholders a discount from the stated principal amount of the debentures (here, a discount of $17 per share), a corporation issuing the debentures (here, National Alfalfa) is not entitled to a discount reduction as for interest paid, amortized over the life of the debentures, for the reason it received for each preferred share at the time it was issued the identical amount of the stated principal payable under each debenture and therefore suffered no loss. And it so held; notwithstanding while the Treasury Regulations originally treated bond discount as a loss, since prior to 1957 they have treated it as interest paid,[1] which is supported by re-

[1] *See American Smelting & Refining Co. v. United States*, 3 Cir., [42-2 USTC ¶ 9670] 130 F. 2d 883, 885 (1942); Treas. Reg. 33, Rev. Art. 150; Treas. Reg. 45, Art. 554(3)(ii); Treas. Reg. 62, Art. 545(3)(a); Treas. Reg. 65, Art. 545(3)(a). The Treasury Regulation in effect during the taxable year here involved is § 1.61-12(c)(3), T. D. 6272, 1957-2 Cum. Bull. 18, 32.

spectable authority, as we shall hereafter show.

The applicable Regulation in effect during the taxable year here involved is Treas. Reg. § 1.61-12(c)(3), T. D. 6272, 1957-2 Cum. Bull. 18, 32, which in part here pertinent reads:

"If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds."

Section 1.61-12(c)(3) was amended in 1968 by T. D. 6984, 1969-1 Cum. Bull. 38, and the pertinent language of the former Regulation was carried over to current Treas. Reg. § 1.163-3(a)(1).

A taxpayer has the unqualified right under the Federal Income Tax statutes to deduct from his gross income in a tax year interest actually paid in such year in a bona fide transaction.

As above stated, the Treasury Department, at all times here pertinent, has held that bond or debenture discount is deductible, not as a loss, but as interest paid, amortized over the life of the bond or debenture.

And as we shall show, infra, with the exception of the Court of Claims, the courts that have passed on the question have held that bond or debenture discount arises when the issuer of bonds or debentures exchanges them for preferred stock or securities theretofore issue by it, of less value than such bonds or debentures, and that such difference in value is deductible as interest prorated over the life of the bonds or debentures.

Assume that National Alfalfa sold 200 of its $50 debentures to John Doe at a discount of $17 per debenture and received $6,600 for such debentures; and in the same tax year that it sold such debentures, it purchased from one of its preferred stockholders 200 shares of its $50 par value preferred stock at the market price of $33 per share. Could there be any doubt that National Alfalfa could deduct from its gross income the $17 discount on each of such debentures so sold as interest paid, amortized over the life of the debentures? We think the answer is obviously "No." Yet the $17 discount, plus $33, is exactly the same amount National Alfalfa received for such preferred shares when it sold them.

Assume the same facts stated in the above example, except National Alfalfa sold such 200 debentures at a discount of $17 per debenture to one of its preferred stockholders; and from the same stockholder in the same tax year purchased 200 shares of its preferred stock for $33 per share. Would there be any doubt of the right of National Alfalfa to likewise deduct from its gross income such $17 discount as interest paid, amortized over the life of the debentures? Again, we think the answer is obviously "No," yet as in the first example the $17 discount, plus $33 per share, is the same amount National Alfalfa received for each share of such preferred stock when it sold it.

In substance, there is no difference between the facts in the instant case and the facts in the second example stated above.

Hence, we hold that the decisions of the Commissioner and the Tax Court in the instant case are based on a nonapplicable premise, viz, that National Alfalfa suffered no loss.

At this point, we think it would be helpful if we show what the result would be if National Alfalfa were permitted to deduct as interest amortized or prorated over the life of the debentures, which was 18 years, the difference between $50, the principal amount of each debenture, and $33, the market value of each certificate of preferred stock, or $17. That amount, prorated over the life of the debentures, would be 95 cents per year on each debenture, and would equal interest thereon at the rate of .019 per year. While the discount, in effect, would be paid in advance, the total deduction could not be taken in the tax year in which the exchange took place. It would have to be amortized over the life of the debentures. The picture looks quite different when the result is thus broken down.

[*Case Precedents*]

The Tax Court relied principally on the decisions of the Court of Claims in *Erie Lackawanna Railroad Company v. United States* [70-1 USTC ¶ 9245], 422 F. 2d 425 (1970), and *Missouri Pacific Railroad Company v. United States* [70-1 USTC ¶ 9457], 427 F. 2d 727 (1970).

In the former case, the Railroad Company, after being authorized so to do by the Interstate Commerce Commission, exchanged its five per cent debentures, due January 1, 2020, for shares of Series "A" five per cent preferred stock. The basis of the exchange was one income debenture in the principal sum of $100 for one share of preferred stock having a par value of $100. The market value of the preferred stock at the time of the exchange of the debentures for stock was $22,558,224.46, which was $5,217,975.54 less than the $27,776,200 maturity value of

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the debentures. The Railroad Company claimed such difference rrpresented bond discount and was deductible as interest paid, amortized over the life of the debentures. The Court of Claims held that the Railroad Company was not entitled to deduct such discount, since the amount received by it for its preferred stock when issued was the same as the principal amount of the debentures, and therefore it suffered no loss in the exchange. In the opinion, the court said:

> "The position which this court does take in regard to the issue at hand is that since plaintiff was exchanging $100 debentures for preferred stock for which it had already received $100 in value, then plaintiff lost nothing as a result of the transaction. Since there was no actual difference between the face value of the debentures and the amount received in return for them ($100 preferred stock), there was no discount which could be amortized over the life of the bonds. The fact that the preferred stock had a market value less than $100 at the time of the exchange is of no consequence in this type of transaction where the plaintiff is purchasing its own stock. What is important in this case is the value received for the stock at the time of its issuance. Since plaintiff issued its stock for $100 per share and carried the stock on its books at this amount, this is the figure which should be used to determine whether a discount has arisen. * * *"

In the latter of the two cases, Missouri Pacific and its subsidiaries reorganized in a proceeding under 11 U. S. C. § 205, pursuant to a plan approved by the Interstate Commerce Commission and the United States District Court having jurisdiction of the reorganization proceedings. Under the plan, Missouri Pacific issued: (1) Collateral trust notes; (2) first mortgage 4½ per cent bonds (series B and C); (3) general mortgage income 4¾ per cent bonds (series A and B); (4) 5 per cent 90-year debentures; and (5) stock in exchange for its own outstanding debt securities and stock of its subsidiaries; and the subsidiaries were merged into the parent corporation.

The terms of the exchange varied. In some cases, bondholders received new debt securities equal in amount to the sales value of the sum total of their bonds, plus interest accrued and unpaid by Missouri Pacific and its subsidiaries during the process of the reorganization. The accrued interest was deducted by Missouri Pacific from its gross income for federal income taxes in the year it became due. It also took deductions for amortized bond discount, predicated on the fact that the aggregate value of the new bonds issued pursuant to the plan was greater than the value of the securities received in exchange, as shown by New York Stock Exchange price quotations. Missouri Pacific claimed that the aggregate maturity value of the bonds was $529,117,141, while the fair market value of the old securities received in the exchange was $452,151,252, or a difference of $76,965,889, and that such difference in value represented debt discount and was deductible as interest amortized over the life of the new bonds. The court held that Missouri Pacific was not entitled to deduct such discount, because the par value of the old bonds when issued was their "true valuation * * * so far as plaintiff (Missouri Pacific) is concerned." The court held that for the purpose of income tax deduction for bond discount, bonds received in exchange for new bonds are in a completely separate category from other types of property received for the new bonds, and that the value of the old bonds so exchanged should be the amount received therefor by Missouri Pacific at the time they were issued, rather than their market value at the time of the exchange. In so doing, the court followed its decision in the Lackawanna case, where it held that the preferred stock of the Railroad Company was received by it in exchange for debentures; that the principal amount of the debentures was the same as that received for the preferred stock when issued; and it suffered no loss in the exchange and no discount was allowed

The two Court of Claims decisions supported the decision of the Tax Court in the instant case, but there is other respectable authority to the contrary. Moreover, the two Court of Claims decisions and the decision in the instant case, as we have heretofore shown, are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered.

And we regard it as anomalous for the Department of the Treasury to hold in the instant case that National Alfalfa suffered no loss when it exchanged a $50 debenture for a share of preferred stock of the market value of $33, since it had received $50 for such share of preferred stock when it sold it, and to hold that the preferred stockholder realized a gain when he exchanged a share of preferred stock of a market value of $33 for a $50 debenture, when he paid $50

for such share of preferred stock when he purchased it.

It is firmly established by the adjudicated cases that where a corporation issues its bonds, including debenture bonds, which unconditionally oblige the corporation to pay the principal amount stated therein, together with interest thereon, at the times therein provided, and receives therefor the amount of the principal, less a discount, the amount of such discount is deductible as interest paid and should be amortized over the life of the bonds or debenture bonds.[3]

The reason for allowing the discount is that it represents the expense of borrowing. It serves "the same function as stated interest"[4] and "represents a part of the cost of the borrowed capital."[5]

The rationale stated above, with respect to the present treatment of discount as the same as interest paid on borrowed money, was followed and applied in a well considered opinion in *American Smelting & Refining Co. v. United States*, 3 Cir. [42-2 USTC ¶ 9670], 130 F. 2d 883. There, bonds were exchanged for preferred stock of a subsidiary of the issuer, when such issuer owned all of the common stock of such subsidiary. The market value of the preferred stock received by the issuer of the bonds was less than the principal of the bonds. The court there rejected the contention made in the instant case, and held that the difference between the sale value of the bonds and the market value of the preferred stock at the time of the exchange represented a discount and was deductible as interest amortized over the life of the bonds.

American Smelting was followed in two subsequent District Court cases in the Fifth and Seventh Circuits, respectively, in *Southern Fertilizer & Chemical Co. v. Edwards*, U. S. D. C. M. D. Ga. [55-1 USTC ¶ 49,133], 167 F. Supp. 879 (1955), and *Industrial Development Corp. v. United States*, D. Ill., 51 A. F. T. R. 1514, 56-2 USTC ¶ 10,066, (1956). Both cases involved the issuance of bonds in exchange for the issuer's preferred stock.[6]

In *Montana Power Company v. United States*, 3 Cir. [56-1 USTC ¶ 9402], 232 F. 2d 541, cert. den. 352 U. S. 843, the court, while disallowing the discount under the facts of that case, at page 546 reaffirmed its decision in the *American Smelting* case.

The case of *Atchison, Topeka and Santa Fe R. Co. v. United States*, 10 Cir. [71-1 USTC ¶ 9430], 443 F. 2d 147 (1971), which was an income tax refund suit, involved the reorganization of the then existing Atchison, Topeka and Santa Fe Railroad Company, hereinafter referred to as the "Old Company." The facts in that case were these:

On December 23, 1893, the Union Trust Company of New York, trustee under the first and second mortgage bonds of the Old Company, filed a complaint in the United States Circuit Court for the District of Kansas, requesting the appointment of a receiver for the properties of the Old Company. Receivers were appointed. On January 1, 1894, the Old Company defaulted in payment of interest on its general mortgage bonds. The Union Trust Company filed a second complaint on March 12, 1894, seeking foreclosure of the mortgage and sale of the railroad's property described in the mortgages. A reorganization took place in 1895, whereby the Atchison, Topeka and Santa Fe Railway Company, hereinafter referred to as the "New Company," the present plaintiff and taxpayer in the action, was organized and acquired all the assets of the Old Company.

After the filing of the first complaint by the Union Trust Company in 1893, bondholder protective committees were quickly formed throughout the country. The stockholders later established the Atchison Protective Reorganization Committee to protect their interests. Following various negotiations, three of the existing bondholder committees created the Joint Executive Reorganization Committee. After arm's length negotiations with the other groups of security holders, the Joint Executive Committee formulated and proposed a plan of reorganization for the Old Company, which was finally approved on April 10, 1895. It proposed the foreclosure of the general mortgage, also referred to as the first mortgage, and the vesting of the properties acquired at the foreclosure sale into the New Company.

[3] *Helvering v. Union Pacific Railroad Co.* [35-1 USTC ¶ 9011], 293 U. S. 282 (1934).
[4] *United States v. Midland-Ross Corp.* [65-1 USTC ¶ 9387], 381 U. S. 54, 57 (1965).
[5] *Helvering v. Union Pacific Railroad Co.* [35-1 USTC ¶ 9011], 293 U. S. 282, 287 (1934).
[6] See also *Nassau Lens Co. v. C. I. R.*, 2 Cir. [62-2 USTC ¶ 9723], 308 F. 2d 39, where in answer to the contention of the Commissioner that "when a seller also becomes a financing medium by taking bonds issued at a discount instead of cash in exchange for property, the tax laws will not recognize a charge for the use of money," the court stated: "We find no support for such an assertion and reject it. See *American Smelting & Ref. Co. v. United States* [42-2 USTC ¶ 9670], 130 F. 2d 883 (3rd Cir. 1942)."

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Under the plan, the general mortgage bondholders, the second mortgage bondholders, and the income bondholders of the Old Company were to place their respective securities in various depositories and receive in exchange therefor certificates of deposit; and the stockholders of the Old Company were to place their stock in various depositories and receive in exchange therefor certificates of deposit. Under the plan, the holders of the second mortgage bonds, of the income bonds, and of common stock were to pay a cash assessment totaling approximately $14,000,000 into a depository in order to be eligible to receive certificates of deposit and to participate in the plan.

The plan specified what the holders of securities of the Old Company, respectively, would receive in bonds, or bonds and preferred stock, of the New Company in exchange for their certificates of deposit, and what the stockholders of the Old Company should receive in common stock of the New Company in exchange for their certificates of deposit.

On August 27, 1895, the Union Trust Company filed a supplemental complaint in the Circuit Court, requesting that the properties of the Old Company be sold as a single parcel. The joint Executive Committee was allowed by the court to intervene in the reorganization proceedings, requested the Union Trust Company to go forward with the sale, and the court so ordered. A special master sold the property for $60,000,000 at a public auction on December 10, 1895, to Edward King, President of the Union Trust Company, Victor Marawetz, and Charles Beeman, all representing the Joint Executive Committee. The court approved the sale on the same day, decreeing that the purchasers could transfer the property to a new corporation, subject to certain restrictions, including provision for paying certain general mortgage bondholders of the Old Company who had elected not to participate in the plan.

The next day, December 11, 1895, the property was deeded to the three men. On December 12, 1895, the Joint Executive Committee incorporated the New Company, and the three men deeded the properties to it. The purchase price recited in the deed was $382,202,500, payable as follows: $96,990,500 par value of the New Company's general mortgage bonds; $51,728,000 par value of the New Company's adjustment mortgage bonds; $131,486,000 par value of the New Company's preferred stock; and 1,019,980 shares ($101,998,000 par value) of the New Company's common stock. The New Company delivered these securities and stock to the Joint Executive Committee, which placed them in the Union Trust Company. The Trust Company eventually effected the exchange of the old certificates of deposit for the securities of the New Company.

The basis of the New Company's claim for an income tax refund was that it issued general mortgage and adjustment bonds in exchange for the intangible claims of the general mortgage bondholders of the Old Company; that the fair inherent value of such claims was less than the par value of taxpayer's bonds issued in exchange therefor, and that such difference constituted discount amortizable for federal income tax purposes.

At the trial below, the court ruled that in substance the bonds of the New Company were exchanged for the bonds of the Old Company, and submitted to the jury the questions of whether the fair market value of the bonds received was less than the par value of the bonds paid, and whether such difference constituted amortizable bond discount. The jury found a difference of $56,480,548, and decided that such amount constituted original issue discount.

This court held that the last step in the transaction determined the substance of what had occurred, and that the New Company issued its general mortgage and adjustment bonds in exchange for the intangible claims of the general mortgage bondholders of the Old Company; that the fair inherent value of such claims was less than the par value of the taxpayer's bonds issued in exchange therefor, and that such difference constituted discount amortizable as interest paid for federal income tax purposes. The court said:

> "Clearly the taxpayer would have been entitled to a deduction for discount had the bonds been sold on the market at a discount, and the proceeds used to purchase the assets of the Old Company."

The court further held that there was no difference in substance between that and what actually happened in the reorganization proceeding, and cited the *American Smelter Company* case, in which it was said:

> "We believe that the discount is still to be treated as additional interest when the subject matter of the loan is stock instead of cash."

The court further stated:

"This view conforms with economic and business reality which recognizes that to the issuer bond interest is reflected both by the stated rate of interest and by the amount below or above par received by the issuer when the bonds are originally distributed. The taxpayer in this case presented substantial evidence from experts in railroad securities and properties who relied on the documents surrounding the reorganization, market conditions and actual trading, and valuation of the railroad properties as establishing the economic basis for and probable existence of discount * * *"

and affirmed the judgment of the lower court.

[*Conclusion*]

We repeat that we are of the opinion that the decisions of the Tax Court and of the Court of Claims are predicated on an unsound premise when they hold that whether or not deductions shall be allowed, because of discount as interest paid, depends on whether the taxpayers claiming such deductions suffered a loss in the transactions.

We hold, because it is now settled by the decisions of the Supreme Court, that the deduction is for interest charged by reason of a discount, and not as a loss suffered by the taxpayer.[1]

The decision of the Tax Court sustaining the deficiency assessed by the Commissioner against National Alfalfa for its tax year ending April 30, 1967, and holding that there was a deficiency in income tax due from National Alfalfa for such tax year of $147,949.76 is REVERSED;

And the case is REMANDED, with instructions to direct the Commissioner to allow National Alfalfa to deduct from its gross income for such tax year that portion of the total debenture discount which is deductible as interest paid, amortized, or prorated over the life of the debentures, 18 years, allocable to such tax year ending April 30, 1967; and also to deduct an amount for loss carryovers from prior years, in view of our holding that the debenture discount was deductible as interest paid, amortized over the life of the debentures, provided National Alfalfa was entitled to take a deduction in its return for its tax year ending April 30, 1967, for losses suffered in prior years, a question not raised nor passed on by this court on this appeal.

[Dissenting Opinion]

HILL, Circuit Judge, dissenting:

No. 72-1125 National Alfalfa Dehydrating and Milling Company v. Commissioner of Internal Revenue.

I am compelled to respectfully dissent from the majority opinion. My colleagues, in rejecting certain cases, in my opinion have done so on the basis of a rule of law gleaned entirely out of context when viewed with other cases in which this same problem is confronted.

The majority reject *Erie Lackawanna Railroad Company v. United States* [70-1 USTC ¶ 9245], 422 F. 2d 425 (Ct. Cl. 1970), and *Missouri Pacific Railroad Company v. United States* [70-1 USTC ¶ 9457], 427 F. 2d 727 (Ct. Cl. 1970), *modified*, [70-2 USTC ¶ 9608] 433 F. 2d 1321 (Ct. Cl. 1970), *cert. denied*, 402 U. S. 944, on the basis that those cases "are based on an erroneous premise, namely, that the question is not whether there was a debenture discount which served the purpose of stated interest, but whether there was a loss suffered." I agree with the majority to the extent that loss is not synonymous with discount, but rather that discount "serves 'the same function as stated interest' and 'represents a part of the cost of the borrowed capital.'" I must conclude, however, the concept of loss as used in those cases is correct when read in context with other cases.

In *St. Louis—San Francisco Railway v. United States* [71-2 USTC ¶ 9544], 444 F. 2d 1102, 1106 (Ct. Cl. 1971), *cert. denied*, 404 U. S. 1017, the court there rejected any discount in either of two exchanges on the basis "that there was an exchange of equals." In analyzing its decision in *Erie Lackawanna*, the court stated discount was not allowed in that case because "equivalents had been exchanged and no discount could be said to arise." When loss is thus analyzed in the context of whether there was a disparity in values in an exchange, those

[1] We are also of the opinion that the case of *Claussen's, Inc. v. United States*, 5 Cir., [72-2 USTC ¶ 9751] — F. 2d —, (decided November 16, 1972, 41 LW 2278) is clearly distinguishable on the facts from the instant case. In that case, the corporation involved not only issued its bonds in exchange for its outstanding Class A and Class B common stock, but also issued its new common stock to each of its old holders of Class A and Class B common stock, in direct proportion to their original equity interest in the corporation. The court held that the common stockholders' equitable posture relative to the corporation and to one another after the exchange was substantially the same as it was before the exchange, and hence no bond discount arose.

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cases rejected by the majority are clearly authoritative.

A further example of application of this "equivalency of exchange" formula is provided in *Cities Service Company v. United States* [70-2 USTC ¶ 9537], 316 F. Supp. 61 (S. D. N. Y. 1970). In that case there was a disparity in values in an exchange of debentures for preferred stock due to the higher value of the debentures being offered in exchange. The court there allowed discount measured by the amount of that disparity. That excess represented the true additional consideration which the company was required to pay in retiring its outstanding preferred stock.

The cases cited applying the equivalency of exchange formula have uniformly held that where the corporation is retiring its own outstanding bonds or stock in an exchange transaction, the value to be ascribed those outstanding bonds or stock shares is the value originally received by the corporation in exchange for that outstanding obligation. I am not persuaded that the cases cited in the majority opinion require fair market value to be ascribed the outstanding obligations, as those cases are distinguishable. Both *Atchison, Topeka and Santa Fe Railway Co. v. United States* [71-1 USTC ¶ 9430], 443 F. 2d 147 (10th Cir. 1971), and *American Smelting & Refining Co. v. United States* [42-2 USTC ¶ 9670], 130 F. 2d 883 (3d Cir. 1942), involved corporations exchanging their debt obligations for the outstanding obligations of another corporation. In both cases, the corporation assuming the outstanding obligations was not the corporation which had originally received the consideration for those obligations. This distinction was noted in *Erie Lackawanna, supra*, and remains viable today, although apparently modified to the extent that the value of outstanding obligations of a subsidiary, when assumed by the parent corporation, is the consideration originally received by the subsidiary rather than the market value of the outstanding obligation.[1] Market value is therefore revelant only when the assuming corporation is other than the corporation which originally issued the obligation.

I would note also that *Southern Fertilizer & Chemical Co. v. Edwards* [55-1 USTC ¶ 49,133], 167 F. Supp. 879 (M. D. Ga. 1955), and *Industrial Development Corp. v. United States*, 51 A. F. T. R. 1514, 56-2 USTC ¶ 10,066 (D. Hl. 1956), on which the majority rely, contain only findings of fact and conclusions of law with no detailed discussion of the question. I therefore, as did the court in *Erie Lackawanna*, reject those cases as authoritative. I likewise distinguish *Montana Power Company v. United States* [56-1 USTC ¶ 9402], 232 F. 2d 541 (3d Cir. 1955), *cert. denied*, 352 U. S. 843, on the facts, as the issue presented there related to proof of value of property originally exchanged for the corporate obligation. We are here confronted with an exchange of a subsequent corporate obligation for a prior obligation.

My close reading of the cases reveals a formula to be followed when a corporation issues its debt obligation in exchange for its own prior outstanding obligation. In applying this formula, the value assigned the outstanding obligation is the consideration received by the corporation when originally issued. Any discount, therefore, is dependent on a showing of disparity in values reflected by the higher value of corporate debt obligation given in exchange. If there is no disparity in value, that is, if there is an equivalency in the exchange, no discount arises. The facts here clearly show only equivalent exchanges. I would, therefore, affirm the decision of the Tax Court.

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[1] *See Missouri Pac. R. R. Co. v. United States* [70-1 USTC ¶ 9157], 427 F. 2d 727 (Ct. Cl. 1970), *modified*, [70-2 USTC ¶ 9698] 433 F. 2d 1324 (Ct. Cl. 1970), *cert. denied*, 402 U. S. 944.

APPENDIX D

In the United States Court of Claims

No. 289-65
No. 303-66

(Decided December 12, 1972)

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY v. THE UNITED STATES

Robert E. Simpson for plaintiff. ***Robert T. Molloy***, attorney of record. ***George E. Bailey***, of counsel.

Frances Folts Kane, with whom was ***Assistant Attorney General Scott P. Crampton***, for defendant. ***Fred B. Ugast***, of counsel.

Before COWEN, *Chief Judge*, DAVIS, SKELTON, NICHOLS, KASHIWA, KUNZIG, and BENNETT, *Judges*.

ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT AND DEFENDANT'S CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT

COWEN, *Chief Judge*, delivered the opinion of the court:

In our decision of July 14, 1971 (herein referred to as *St. Louis No. 1*), in these related tax cases, we decided several issues relating to the measurement of debt discount claimed as the result of the exchange of new debt obligations for outstanding debt obligations and outstanding stock. *St. Louis-San Francisco Ry.* v. *United States*, 195 Ct. Cl. 343, 444 F. 2d 1102 (1971), *cert. denied*, 404 U.S. 1017 (1972). The parties' pending cross-motions for summary judgment require us to decide two additional issues that were not raised in the earlier decision and one which both parties now agree is governed by *St. Louis No. 1*.

I

The Reduction of Basis

In *St. Louis No. 1*, we held that because plaintiff had failed to raise the reduction-in-basis issue (as it relates to depreciable property) in its claim for refund, it could not assert the claim on motion for summary judgment. However, this holding did not foreclose plaintiff from asserting the claim as an offset to offsets claimed by defendant. Plaintiff was allowed to file an amended reply to defendant's first amended answer, and plaintiff's current motion is based on this newly pleaded issue.

In 1959, 1960, and 1962, plaintiff reacquired a portion of the debentures that it had issued in 1956 in exchange for outstanding preferred stock. Upon audit, the IRS determined that the reacquisition resulted in a gain, but plaintiff elected to have the gain excluded from its income pursuant to Section 108(a) of the Internal Revenue Code of 1954.[1]

Plaintiff executed Treasury Consent Form 982, which is a prelude to the reduction in the tax basis of certain property to the extent of the unrecognized gain. Section 1017 of the Internal Revenue Code of 1954 is the statutory authority for this reduction.

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[1] SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS.

(a) *Special Rule of Exclusion.*—No amount shall be included in gross income by reason of the discharge in whole or part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if—

(1) the indebtedness was incurred or assumed

(A) by a corporation, or

(B) by an individual in connection with property used in his trade or business, and

(2) such taxpayer makes and files a consent to the regulations prescribed under section 1017 (relating to adjustment of basis) then in effect at such time and in such manner as the Secretary or his delegate by regulations prescribes.

In such case, the amount of any income of such taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction.

[We note that § 108(b) does not apply since this was not a discharge, cancellation, or modification affected by an order of a court in a receivership proceeding.]

Plaintiff desired to have the basis of the preferred stock reduced but was rebuffed by the Commissioner. In *St. Louis No. 1* we held that the Commissioner's ruling was correct, because the preferred stock was no longer in existence for the years 1959, 1960, and 1962. The Commissioner did allow a reduction in basis of plaintiff's depreciable property but restricted the reduction to ratably depreciable property. By "ratably depreciable property", we understand that defendant means the kind of property in which the cost or other basis is ratably spread over its estimated useful life during which annual deductions for depreciation are made in accordance with some accounting method such as the straight-line method. In addition to its ratably depreciable property, plaintiff also owns non-ratably depreciable property, *e.g.*, track and rails. Plaintiff depreciates these items by the use of retirement-replacement-betterment method of depreciation (herein referred to as RR&B method). Recently, we had occasion to review the definition and application of the RR&B method in *Chicago, Burlington & Quincy R.R. v. United States*, 197 Ct. Cl. 264, 455 F. 2d 993 (1972), *cert. granted*, 409 U.S. — (1972). Consequently, we will not repeat that discussion except to the extent necessary to the decision in this case.

The basis adjustment regulation upon which taxpayer asserts its offset was promulgated at the behest of Congress when the predecessor to section 1017 was made a permanent provision in 1951.[2] It would be difficult to imagine a broader delegation of the legislative prerogative than the authority granted to the Secretary in this instance:

> SEC. 1017. DISCHARGE OF INDEBTEDNESS.
>
> Where any amount is excluded from gross income under section 108(a) (relating to income from discharge of indebtedness) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of *any* property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. *The amount to be so applied* (not in excess of the amount so excluded from gross income, reduced by the amount of

[2] Revenue Act of 1951, ch. 521, § 304, 65 Stat. 452.

> any deduction disallowed under section 108(a)) *and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Secretary or his delegate) in effect at the time of the filing of the consent by the taxpayer referred to in section 108(a)* * * *. [Emphasis added.]

The anticipated amendment to the regulation was promulgated on April 2, 1953,[3] and is represented in applicable part by the current regulation § 1.1017–1(b)(7):

> Any reduction in basis which remains to be taken (by reason of an exclusion from gross income under section 108(a)) after the application of paragraph (a)(1) of this section *shall be applied first against property of a character subject to the allowance for depreciation under section 167* * * *. [Emphasis added.]

There is no doubt that the RR&B method of accounting is an acceptable method for depreciating property under section 167 of the Code, and defendant conceded that fact in oral argument. Approval of this method of accounting by the Internal Revenue Service has been an established fact at least since 1940 when the Seventh Circuit decided *Chicago & North Western Ry.* v. *Commissioner*.[4] *The Boston & Maine R.R.* v. *Commissioner*[5] case, decided three and one-half months after the above-quoted regulation was promulgated, again approved this method as an acceptable method under the provisions of the predecessor to section 167. Additionally, in Revenue Ruling 67–22, the Commissioner stated that "both the railroad industry and the Internal Revenue Service use 'retirement method' to mean a method of accounting for depreciation."[6]

That would seem to end the matter. Since it is undisputed that the taxpayer's RR&B property is of the "character subject to the allowance for depreciation under section 167," the basis of such property is qualified for reduction under section 1017.

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[3] T.D. 6003 (1953 CUM. BULL. 24) (Treas. Regs. 111 (1939 Code), § 29.113(b)(3)-1(G)).

[4] 114 F. 2d 882 (7th Cir. 1940), *cert. denied*, 312 U.S. 692 (1941). In this decision, it was the Government that relied on the method as the proper method of depreciation.

[5] 206 F. 2d 617 (1st Cir. 1953).

[6] 1967-1 CUM. BULL. 52.

However, defendant would have us re-write its regulation to differentiate between ratably and non-ratably depreciable property, both of which are of a "character subject to the allowance for depreciation under section 167." The Government contends that while the RR&B method is an appropriate method for use under section 167 in other circumstances, the allowance of plaintiff's claimed reduction in the basis of RR&B property would be contrary to the intent of Congress as revealed in the Senate Report accompanying the Revenue Act of 1951. The Senate Report [7] states in pertinent part:

> The Secretary of the Treasury has authority under section 113(b)(3) [section 1017 of the 1954 Code] to prescribe regulations which will set forth rules under which the adjustment to basis shall be made * * *. In order to assure that the exclusion of income by operation of section 22(b)(9) [section 108(a) of the 1954 Code] may result only in a temporary postponement of the tax liability, your committee understands that the Secretary of the Treasury will require by regulations that, after adjustment of the basis of certain property acquired with the purchase money indebtedness, whatever reduction in basis of property remains to be taken under section 113(b)(3) will be taken, *in general*, against depreciable property or property subject to cost depletion and only as a last resort against nondepreciable property. Thus, in general, it is intended that a reduction in the basis of nondepreciable property will be made only after the exhaustion of depreciable property or property subject to cost depletion. This provision will assure the collection within a reasonable time of the taxes postponed and will, therefore, have no appreciable long-run effect on the revenue. [Emphasis added.]

After a careful reading of the Senate Report, we cannot agree with defendant's contention that Congress clearly intended that the proposed regulation would apply only to ratably depreciable property. Furthermore, we find no support for defendant's argument that the RR&B method was not considered a method of depreciation at that time and was not comprehended by the regulation. It is true that the Senate Committee understood that the regulation would distinguish

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[7] S. REP. No. 781, 82d Cong., 1st Sess. 59-60 (1951-2 CUM. BULL. 458, 500).

between depreciable and non-depreciable property and that Congress intended that a reduction in the basis of nondepreciable property would be made only after the exhaustion of depreciable property. The statement was also made that a regulation containing such a provision would assure the collection of the postponed taxes in a reasonable time and would have no appreciable long-run effect on the revenue. However, no reference whatever was made to non-ratably depreciable property, and there is no indication that the Senate Committee had its attention called to or considered in any way the interpretation of the regulation which defendant now urges upon us.

In contrast to the lack of any expression of the congressional intention with respect to the precise issue before us, we have the very broad delegation of legislative authority to the Secretary of the Treasury under the provisions of section 1017. The regulation in issue is a legislative regulation, which is the statute itself. It is to be differentiated from an interpretative regulation, which is one that rephrases the statute to give it body.[8] The adoption of defendant's interpretation would require a redrafting of the regulation, excluding any reference to section 167. We find nothing in the legislative history which authorizes or requires us to take that action.

In promulgating the regulation, the Internal Revenue Service adopted a shorthand method of dealing with a complex problem. It used a rational approach by the reference to section 167. An amendment of this legislative regulation to conform with defendant's arguments would require congressional hearings, or at least compliance with established Internal Revenue Service procedure for changes in the regulations and a careful weighing of the ramifications of proposed changes on various types of depreciable property.

The defendant argues that except where there is a complete abandonment or retirement of track without replacement, the tax lost as a result of the reduction in the basis of such property will not be recouped. The result, the defendant says, is to thwart the congressional purpose of avoiding an appreciable long-run effect on the revenue. It is true that only a small portion of railroad track or rails is retired every year, but

[8] *See* Griswold, *A Summary of the Regulations Problem*, 54 HARV. L. REV. 398, 401 (1941).

more of this property is retired in some years than others. All of this is contemplated by section 167 for, as the court said in *Boston & Maine R.R.* v. *Commissioner, supra:*

> * * * [T]he underlying theory of the retirement method is that the charges to expense on account of all the items retired or replaced in any particular year are taken as a rough equivalent of what would be a proper depreciation allowance for *all* the working assets of the company for that year. The assumption is that once the system is functioning normally and the retirements are staggered fairly regularly, the charges to expense on account of equipment wearing out or otherwise disappearing from service are spread out and stabilized, and hence will approximate the results under straight-line depreciation. [9] * * *

Long range effects on the revenue are also brought about when there is a reduction in the basis of ratably depreciable property that has a useful life of more than 50 years. We believe that the Treasury had this in mind when it issued the regulation before us. We must also presume that the Treasury knew that RR&B property was of a "character subject to the allowance of depreciation under section 167." After all, the *Chicago & North Western* case had been decided 13 years earlier. *Boston & Maine*, decided a little over 3 months after the regulation was promulgated, was a signal that the regulation would have to be amended if it were to mean something other than what is clearly expressed by its terms. The fact that the regulation has remained unchanged for 19 years is, it seems to us, an indication of an administrative determination that when all the factors involved are considered, the use of the section 167 approach is the best means of carrying out the intent of Congress.

The use of the section 167 approach also gives a degree of certainty in an area where the need for certainty is high. As Professor Eustice points out:

> The dictates of practical administration of the tax laws demand a reasonable degree of certainty in their application, especially where a problem cuts across so many phases of business and personal activity as does the debt cancellation situation.[10]

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[9] 206 F. 2d at 619.

[10] Eustice, *Cancellation of Indebtedness and the Federal Income Tax: a Problem of Creeping Confusion.* 14 TAX L. REV. 225 (1959).

In summary, we hold that the regulation, unamended by the interpretation which defendant advocates, conforms to the intent of Congress. If a line is to be drawn between ratably depreciable property and non-ratably depreciable property, as defendant argues, it would be equally logical and necessary to provide a distinction between short-lived ratably depreciable property and similar property having a very long estimated useful life. In view of the clear and unambiguous language of the regulation, the fact that it has remained unchanged for so many years, and the long history of approval of the RR&B method under section 167 and its predecessors, plaintiff had a right to rely on the regulation according to its terms. Since plaintiff's claim meets the requirements of section 1017, section 167, and the regulation, plaintiff is entitled to the offsets now claimed.

II

Unamortized Debt Discount Carryover

In the 1947 reorganization, plaintiff's outstanding common and preferred stocks were eliminated as worthless. The outstanding debt was cancelled and the holders of the several classes of indebtedness received new bonds, preferred and common stock, and cash in satisfaction of their claims against plaintiff. After an audit of plaintiff's tax returns for 1947 and 1948, the Internal Revenue Service allowed the taxpayer to carry over unamortized discount and expense from its old bonds allocated to its new bonds, in the amount of $1,643,610.82. For the years in suit, the amortized deductions amounted to more than $23,000 per year.

As an offset, defendant now urges that the Service's action in allowing the carryover was erroneous. We agree. This issue is governed by our decision in *Chicago, Milwaukee, St. Paul and Pacific R.R.* v. *United States*, 186 Ct. Cl. 250, 404 F. 2d 960 (1968). In that case, we held that issuance expense would be treated as would discount, and this being so, there could be no carryover of debt discount or issuance expense if the maturity value of the new bonds is less than the amount that was received when the old securities were issued.

We also held that when common or preferred stock is substituted for a debt, the principal of the debt is no longer

to be paid at a fixed future date. Therefore, the discount and issuance expense attributable to the issuance of the old debt for which the stock is substituted is not deductible after the substitution is made.

It is established in this case that the net amount which plaintiff received upon the issuance of the old debt obligations that were cancelled in the 1947 reorganization was substantially greater than the total maturity value of the new bonds issued in exchange for the old obligations. In the 1947 reorganization, plaintiff also issued preferred and common stock having a par or stated total value of $120,763,545. Although the value of the stock is not to be computed in determining entitlement to the unamortized discount, computations based on the admission of the parties show that the addition of the value of the stock to the maturity value of the new bonds produces a total which is still considerably less than the amount received for the old bonds. The cash which plaintiff paid for interest due on the old debt in the 1947 reorganization is likewise not to be taken into account, because it was issued in a one-for-one exchange.

As its final argument on this issue, plaintiff urges that we should reconsider our decision in *Chicago, Milwaukee* because it is in possible conflict with *Southwest Grease & Oil Co.* v. *United States*, 308 F. Supp. 107 (1969), modified in part, 435 F. 2d 675 (10th Cir. 1971). We think plaintiff misreads *Southwest*. In that case the taxpayer redeemed outstanding bonds at a premium, whereas here, plaintiff redeemed its old bonds at substantially less than the net amount received when the old bonds were issued. For each $1,000 bond, Southwest gave $1,290 in cash and new bonds. Therefore, deductions were allowed for both the premium and the issuance expense of the old bonds. This is totally different from the instant cases where taxpayer's new debt was substantially *less* than the old debt. The substantially lower new debt extinguished the discount, and as we said in *Chicago, Milwaukee*, "[t]here was nothing left to amortize."

Since the allowance of the carryover of the unamortized discount and expense was erroneous, plaintiff's recovery in

these cases should be reduced by the amount of the erroneous allowances.

III

Original Issue Discount

In its motion for partial summary judgment in *St. Louis No. 1*, plaintiff claimed original issue discount for the years 1955, 1956, 1959, 1960 and 1961. In its reply to defendant's first amended answer in Docket No. 289-65, plaintiff alleged that it was entitled to original issue discount deductions for each of the years 1947 through 1955. Plaintiff now agrees that the issue with respect to the additional years mentioned was determined in defendant's favor by our decision in *St. Louis No. 1*. Therefore, defendant's motion for partial summary judgment on this question should be granted.

Conclusion

Plaintiff's motion for summary judgment on Issue I is granted, and defendant's motion for partial summary judgment on Issues II and III is granted. The cases are remanded to the trial commissioner pursuant to Rule 131(c) for further proceedings consistent with this opinion.

DAVIS, *Judge*, dissenting in part:

I join with the court on "Unamortized Debt Discount Carryover" (Part II) and "Original Issue Discount" (Part III) but diverge on "The Reduction of Basis" (Part I). The latter question is very close. The court relies most heavily on the literal wording of the regulation which can easily be read without strain in the taxpayer's favor, as the court does. The counterforce, for me, is the overall purpose of Congress, in §§ 108 and 1017, not to put off indefinitely the taxation of gain from the reacquisition of corporate indebtedness.

The 1951 Senate Committee report (S. REP. No. 781, 82d Cong., 1st Sess. 59-60, 1951-52 CUM. BULL. 458, 500), quoted in the majority opinion, indicates that the "exclusion of income by operation of section 22(b)(9)" [now § 108(a)] should "result only in a temporary postponement of the tax liability", and that placing the exhaustion of nondepreciable

property after the exhaustion of depreciable property (or property subject to cost depletion) "will assure the collection within a reasonable time of the taxes postponed and will, therefore, have no appreciable, long-run effect on the revenue." Under plaintiff's system of retirement accounting, that goal will not be at all achieved. The taxes postponed will not be collected in substantial measure unless the track and rails are wholly abandoned without replacement (an unlikely event as to any major segment of the road), or the railroad goes out of business (and in the latter case, as defendant points out, the company is unlikely to have any taxable income).[1] In other words, because the replacement of rails and tracks is expensed annually and the railroad does not use depreciation deductions as a means of gradually recouping the cost of those items, the basis-reduction sought by the taxpayer will not have the effect Congress envisaged of simply extending for a reasonable period the taxation of the gain on the reacquisition of the preferred stock, but will rather result in the indefinite postponement of most of the tax on that gain (with a good chance that it will never be taxed).

The court points out, in answer, that in the ratable system of depreciation many properties have a useful life of 50 years or more, hardly a temporary period. But the difference is that in those instances the reduction in basis, under the regulation, would lead at once to a pro rata reduction in the annual depreciation deductions, and thus to a gradual but continuous recovery of the postponed tax. Under plaintiff's view, there would be no such steady (though extended) payment of the tax.

In this light, the wording of the regulation does not seem to me to be decisive. Although we now consider the retirement-replacement-betterment system a general system of tax depreciation, that was not so clear in early 1953 when the regulation was promulgated. The broad language

[1] For its track and rails, the plaintiff does not reduce its income tax by depreciation deductions (which, of course, are intimately related to the basis of the property being depreciated) but by full deductions for replacements as if they are repairs (and for retirement if the property is permanently retired without replacement). The calculation of the replacement deductions has no necessary connection with the basis of the particular property; a reduction in basis under the regulation will therefore not reduce the allowable deductions.

of *Boston & Maine R.R.* v. *Commissioner*, 206 F. 2d 617 (C.A. 1, 1953), was not yet on the books, and in the litigation of that case the Revenue Service obviously did not consider the retirement system a method of depreciation for all tax purposes. True, *Chicago & North Western Ry.* v. *Commissioner*, 114 F. 2d 882, 885-86 (C.A. 7, 1940), *cert. denied*, 312 U.S. 692 (1941), had accepted, over the railroad's protest, the Service's designation of the retirement system as a proper method of computing depreciation deductions under the predecessor of § 167, but that did not necessarily mean that rails and tracks were "property of a character subject to the allowance for depreciation" (the terms of the regulation now involved). There could be different characterizations for different purposes. The Service may have been thoughtless in letting this language remain unqualified after the *Boston & Maine* opinion, but that neglect does not override, in my opinion, the indications that neither the Congress nor the Treasury expected the regulation to be applied as plaintiff would have it.

Nor does it not seem to me stretching the words too far to exclude (because the purpose so requires) the plaintiff's replacement system for rails and track. The literal language is not that compelling or rigid. It is possible, in this setting, to read a "reduction in basis" to be applied "first against property of a character subject to the allowance for depreciation under section 167" as limited to property the basis of which is significant in the computation of the depreciation deduction and, conversely, as designating replaced property as not "of a character subject to the allowance for depreciation."

In sum, I deem fulfillment of the legislative goal in this particular context as more important than adherence to the normal understanding, in other contexts, of the general language of the regulation, and believe that there is an acceptable reading of the regulation which advances rather than negates the Congressional aim.

NICHOLS, *Judge*, joins in the foregoing dissenting opinion.

In the United States Court of Claims

No. 289-65

No. 303-66

(Decided July 14, 1971)

ST. LOUIS-SAN FRANCISCO RAILWAY COMPANY v. THE UNITED STATES

George K. Dunham, for plaintiff. *Robert T. Molloy*, attorney of record. *George E. Bailey* and *Robert E. Simpson*, of counsel.

E. Alan Moorhouse, with whom was *Assistant Attorney General Johnnie M. Walker*, for defendant.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, *Judges*.

ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT RESPECTING THE DEBT DISCOUNT ISSUE AND DEFENDANT'S CROSS MOTION FOR PARTIAL SUMMARY JUDGMENT

COWEN, *Chief Judge*, delivered the opinion of the court:

These cases come before the court on cross-motions for partial summary judgment. Plaintiff is seeking tax refunds for the years of 1953 through 1961. At issue in this proceeding are the years 1955 through 1961. The main question before us now is the troublesome one of the existence and measurement of debt discount when a corporation exchanges new debt obligations for its outstanding debt obligations and its outstanding stock. Since two exchanges are involved, we will consider each separately before discussing the other issues raised in the parties' motions.

I

The 1947 Reorganization

In 1947 plaintiff St. Louis-San Francisco Railway Company underwent a reorganization pursuant to Section 77 of the Bankruptcy Act.[1] Under the plan adopted, plaintiff exchanged new stock, new bonds, and cash for outstanding bank loans, bonds, and accrued interest.[2] Before the exchange, the face value of this outstanding debt and interest totaled $363,789,651. Plaintiff gave up in the exchange securities having a maturity value and a par value of $244,856,494. The aggregate maturity value of the new bonds totaled $120,935,000, and their market value, as established by New York Stock Exchange quotations, totaled $91,866,411. A schedule of the reorganized company shows that in no instance did the face value of the bonds issued exceed the principal amount of the old debt. See *McCullough* v. *United States*, 170 Ct. Cl. 1, 24-25, 344 F. 2d 383, *cert. denied*, 382 U.S. 901 (1965). Plaintiff tells us that the market value of the old debt equaled $91,866,411. The figure was apparently computed on plaintiff's assumption that fair market value equivalents were exchanged.

Plaintiff contends that it is entitled to amortize the difference between the maturity value of the new bonds and the fair market value of old debt as debt discount. This difference, according to plaintiff, would be $29,068,089, amortizable over the life of the bonds. Plaintiff relies on Treasury Regulation 1.163-3 and *American Smelting & Ref. Co.* v. *United States*, 130 F. 2d 883 (3rd Cir. 1942). In the alternative, plaintiff argues that a trial would be necessary if we adhere to our decisions in *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. 682, 422 F. 2d 425 (1970) and *Missouri Pac. R.R.* v. *United States*, 192 Ct. Cl. 318, 427 F. 2d 727 (1970), *modified on reconsideration*, 193 Ct. Cl. 257, 433 F. 2d 1324 (1970), *cert. denied*, 39 U.S.L.W. WEEK 3486 (May 3, 1971).

On the other hand, defendant says that fair market value is irrelevant when the corporation exchanges its own debt

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[1] Plaintiff is an accrual basis taxpayer for the years in question.

[2] Claims of the common and preferred stockholders and unsecured creditors were eliminated from the capital structure as worthless.

obligations. Defendant further contends that no trial is necessary, because the undisputed facts establish that no discount arose in the exchange. For both arguments, defendant relies on *Missouri Pacific, supra.*

After a review of our decisions in *Erie Lackawanna* and *Missouri Pacific*, we find no reason to change the rules set forth in those cases with respect to the existence and measurement of debt discount when a corporation issues new bonds in exchange for its outstanding debt. In this case, the plaintiff engaged in a reorganization—a recapitalization in which no new capital or assets were added. The secured creditors received new bonds, preferred stock, common stock and cash. The maturity value of the new bonds was less than the face value of the old bonds.

In *Missouri Pacific, supra.* we held contrary to the position now taken by plaintiff with reference to the use of fair market value for measuring debt discount. In that case, we said "The fact that the fair market value of the old bonds may be less than the face value of the new bonds can in no way reduce the amount of value originally paid to plaintiff for the old securities." 192 Ct. Cl. at 321, 427 F. 2d at 731. Applying the rule announced in that case, we find that no debt discount arose in the 1947 reorganization, because the maturity value of the new debt did not exceed the maturity value of the old debt. There is no dispute about that fact and thus no trial is necessary. Since plaintiff incurred no discount in the issuance of the new bonds in the 1947 reorganization, it is entitled to no deductions for the claimed discounts during the years in suit.[3]

II

The 1956 Exchange

In 1956 plaintiff exchanged Series A. five percent Income Debentures bearing a maturity date of January 1, 2006, plus cash and common stock for its outstanding Series A. five percent Preferred Stock, issued in the 1947 reorganization.

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[3] On the assumption that the bonds issued in 1947 were issued at a discount, plaintiff makes certain additional claims. However, we need not consider these, because plaintiff concedes (page 26 of its Reply Brief) that a decision that the bonds were not issued at a discount precludes recovery on the additional claims.

For each $109 par value share of preferred stock surrendered, the holders of the preferred stock received a $100 maturity value Series A Debenture, one quarter share of common stock, and cash amounting to the unpaid portion of the dividend on the preferred stock.

In the aggregate, plaintiff exchanged debentures having a face value of $33,129,000 and 82,823 shares of no par common stock for 331,290 shares of preferred stock which had a total par value of $33,129,000. The market value of the preferred stock, based on New York Stock Exchange quotations, averaged $22,908,118.35 over the period of the exchange. After the exchange was completed, the preferred stock was cancelled and retired.

This transaction was considered by the Internal Revenue Service a reorganization under Section 368(a)(1) of the Internal Revenue Code of 1954—a recapitalization under section 368(a)(1)(E).

In claiming that the 1956 exchange gave rise to amortizable debt discount, plaintiff's primary contention is that the fair market value of the preferred stock ($22,908,118.35) subtracted from the maturity value of the debentures ($33,129,000) is the measurement of debt discount. Thus, plaintiff has computed an amortizable discount of $10,220,881.65.

Plaintiff does not contend that the maturity value of the debentures issued in 1956 exceeded the amount it received when it issued the preferred stock in the 1947 reorganization. Indeed, the facts show that in the 1947 reorganization, plaintiff issued the preferred stock (received in the 1956 exchange), plus common stock and two issues of new bonds having a combined maturity, par, or stated value of approximately $244,856,000 in satisfaction of claims totaling $363,789,000—an amount which exceeded the par and stated value of the stock and bonds issued in 1947 by more than $100,000,000.

The question as to whether original debt discount arises when there is an exchange of debt for equity has been before the court twice in recent years. In *Erie Lackawanna*, we rejected the use of fair market value as a determinative measurement of debt discount when bonds were exchanged for preferred stock. The key element in that case was the *value*

to the corporation of the stock received in the exchange and that value was what had been paid in for the stock. Since the preferred stock in that case had been issued in exchange for the cancellation of debt equal to the par value of the stock, we held that when $100 par value shares were exchanged for $100 maturity value debentures, equivalents had been exchanged and no discount could be said to arise.

In *Missouri Pacific*, 192 Ct. Cl. 318, 427 F. 2d 727 (1970), where bonds were exchanged for stock, we adhered to our decision in *Erie Lackawanna* by stating that when bonds are issued in exchange for stock, debt discount is to be measured by the difference between the face value of the new bonds and the amount originally paid for the stock. On reconsideration (193 Ct. Cl. 257, 433 F. 2d 1324 (1970)), we further refined the measurement by deciding that the amount originally paid in for the stock was the floor in computing debt discount but that the stock could have a greater value in the eyes of the corporation. This greater value was to be determined only after consideration of relevant information, including the market value of the stock, the financial conditions of the taxpayer at the time of the exchange, profit prospects, and expert opinion.

Plaintiff has argued that if we adhere to our decision on reconsideration in *Missouri Pacific*, *supra*, and reject the use of fair market value in determining debt discount, we should order a trial to determine the amount actually paid in for the preferred stock. We again reject the fair market value of the preferred stock in this type of transaction as determinative of the value of the shares to the corporation.

However, no trial is needed, because it is established here, as in *Erie Lackawanna*, that there was an exchange of equals, and as in *Erie Lackawanna*, plaintiff in the 1956 exchange got back one $100 par value share of preferred stock for each $100 debenture given up. Accordingly, plaintiff is entitled to no deduction on account of a claimed discount arising out of the 1956 exchange.

We would reach the same result by holding that the value to plaintiff of the preferred stock, received in exchange for the debentures, was significantly greater than what was initially paid in for the stock or its market value as shown

by stock market quotations at the time of the exchange. In *Missouri Pacific* we said that all relevant factors, including the financial condition of the corporation, should be considered. The plaintiff reported to its shareholders that the exchange would increase its after-tax earnings by over $800,000 per year, without considering any saving due to a determination that it incurred debt discount. Considering this factor, we think that a receipt of stock that increased plaintiff's after-tax earnings by more than $800,000 per year cannot be said to be worth less than the face value of the bonds exchanged for the stock.

Plaintiff makes an additional argument with respect to the common stock, which in addition to the debentures, was exchanged for the preferred stock in the 1956 transaction. Plaintiff says that if it is assumed that each share of the preferred stock had a value of $100, plaintiff incurred debt discount in the amount of the value of the common stock given up in the exchange. Thus, plaintiff contends that if each share of common stock was worth $10, the debt discount should be computed by multiplying the total number of shares of common stock by $10.

Wholly apart from our alternate holding on the 1956 transaction, we find that this contention is without merit. In *Missouri Pacific*, we eliminated the value of new stock which, in addition to bonds and notes, was given in exchange for the corporation's outstanding debt securities and stock from consideration in determining debt discount, 192 Ct. Cl. at 321, n. 4, 427 F. 2d at 729, n. 4. In an analogous situation, we ignored the issuance of preferred stock in determining whether there was a carry-over of debt discount and compared only the maturity value of new bonds and cash with the face value of the old bonds given up in the exchange. *Chicago, Milwaukee R.R.* v. *United States*, 186 Ct. Cl. 250, 263, 404 F. 2d 960, 967 (1968).

Common stock is not a fixed debt obligation, and the plaintiff made no definite obligation for the future by issuing those shares.

In addition, it is very difficult to assume that the preferred stockholders who surrendered their preferred shares in 1956 for the debentures believed, or had any reason to believe,

that they were realizing additional interest income through the exchange (because of a debt discount due to the issuance of the common stock). The taxpayer cannot alter or repudiate its bargain to the detriment of the other side of the exchange, at this late date, in order to obtain a tax advantage for itself. *Cf. Bethlehem Steel Corp* v. *United States*, 193 Ct. Cl. 459, 434 F. 2d 1357 (Dec. 11, 1970); *Commissioner* v. *Danielson*, 378 F. 2d 771, 775 (3rd Cir.), *cert. denied*, 389 U.S. 858 (1967).

III

The Reacquisition of Debentures

In 1959, 1960, and 1962,[4] plaintiff reacquired some of the debentures it issued in 1956 for preferred stock. The Internal Revenue Service on audit determined that plaintiff realized a gain on these transactions. The gain was computed on the basis of the maturity value of the debentures less retirement costs and unamortized issuance expense. The plaintiff elected to have these gains excluded from income under section 108(a) and signed Treasury Consent Forms 982 to have the tax basis of its property reduced pursuant to section 1017 by the amount of the gains so excluded from income.[5] In the consent, plaintiff requested that the gain, if

[4] The issues relating to 1962 are based on a carryback loss from 1962 to 1961 and are included in plaintiff's 1961 refund claim.

[5] Sections 108 and 1017 read:

"§ 108. INCOME FROM DISCHARGE OF INDEBTEDNESS

(a) *Special rule of exclusion.*—No amount shall be included in gross income by reason of the discharge, in whole or in part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if—

(1) the indebtedness was incurred or assumed—

(A) by a corporation, or

(B) by an individual in connection with property used in his trade or business, and

(2) such taxpayer makes and files a consent to the regulations prescribed under section 1017 (relating to adjustment of basis) then in effect at such time and in such manner as the Secretary or his delegate by regulations prescribes.

In such case, the amount of any income of such taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction."

* * * * * *

Footnote continued on p. 8.

any, reduce the basis of the preferred stock acquired through the issuance of the debentures. The Commissioner of Internal Revenue refused and reduced the basis of plaintiff's property subject to ratable depreciation. The Commissioner did not reduce the basis of plaintiff's property which was subject to the retirement-replacement method of depreciation.

Plaintiff first argues that the issue price of the debentures controls the computation of gain. We agree. The actual issue price, the value of what plaintiff received for the debentures, controls any determination of gain on the cancellation of indebtedness. Treas. Reg. 1.61-12(c); *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931); *Fashion Park, Inc.* 21 T.C. 600 (1954).

However, we have already found that the issue price of the bonds was their maturity value. The value of the stock received by the plaintiff was equivalent to the maturity value of the bonds. Therefore, the Service properly computed the gain on the cancellation of indebtedness.

Plaintiff next argues that these gains should be applied to reduce plaintiff's basis in the preferred stock, the specific property for which the debentures were issued. Treas. Reg. 1.1017-1(a)(1). However, section 1017 clearly requires that the property be held or acquired during the tax year the income is realized. Here the preferred stock was no longer in existence for the years 1959, 1960, and 1962, because it was cancelled or retired immediately after the completion of the 1956 exchange.

Plaintiff's third contention on this issue is that the Commissioner of Internal Revenue erred in failing to reduce the

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Footnote 5—Continued

"§ 1017. DISCHARGE OF INDEBTEDNESS

Where any amount is excluded from gross income under section 108(a) (relating to income from discharge of indebtedness) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under section 108(a)) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Secretary or his delegate) in effect at the time of the filing of the consent by the taxpayer referred to in section 108(a). The reduction shall be made as of the first day of the taxable year in which the discharge occurred, except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began."

tax basis of all depreciable property owned by it, as required by Reg. 1.1017-1 (b) (7). It is contended that the retirement-replacement method of accounting (which plaintiff uses) is a form of depreciation. Therefore, plaintiff maintains that the Commissioner erred in reducing only the basis of property subject to ratable depreciation.

Defendant counters with two arguments--one attacking the claim on substantive grounds and the other alleging a procedural defect. We do not reach the substantive issue because we find, as defendant contends, that plaintiff did not assert this ground for recovery in its administrative claim for refund and thus cannot now raise it. Section 7422; *United States* v. *Felt & Tarrant Mfg. Co.*, 283 U.S. 269 (1931); *Union Pac. R.R.* v. *United States*, 182 Ct. Cl. 103, 389 F. 2d 437 (1968).

In its claim for refund before the Commissioner of Internal Revenue for 1961 (which is representative), plaintiff sought:

> In each of the aforesaid years taxpayer filed Consent Form 982, electing to exclude the alleged profit set forth above under Section 108(a) and to reduce the basis of property under Section 1017 of the Code. In said Consent, taxpayer stated that it did not concede that the issue price of the debentures was equivalent to the face amount thereof. Taxpayer further requested that the gain, if any, resulting from the acquisition of the Debentures, as finally determined by agreement with the Internal Revenue Service or by a court of competent jurisdiction, should be applied to reduce basis of the specific property acquired; i.e., the Preferred Stock. The Examining Agent refused to reduce the basis of the specific property acquired as requested by taxpayer and, in lieu thereof, applied the general rule and reduced the basis of all of taxpayer's depreciable property to the extent of the amounts of "profit" set forth above. As a result of such reduction in basis, the Examining Agent disallowed deductions for depreciation as follows:
>
> | | |
> |---|---|
> | 1959 | $9,367.70 |
> | 1960 | 9,314.09 |
> | 1961 | 7,949.38 |
> | 1962 | 21,521.89 |
>
> It is the contention of taxpayer that the action of the Examining Agent as explained above was erroneous,

> and that it is entitled to the deductions for depreciation improperly disallowed as aforesaid. * * *

A careful reading of the claim for refund shows that plaintiff asserted that the error of the Internal Revenue Service was its refusal to reduce the basis of the specific property acquired, *i.e.*, the preferred stock, and that the reduction in the basis of "all of plaintiff's depreciable property" to the extent of the profit plaintiff made on the acquisition of the debentures resulted in an improper disallowance of deductions for depreciation. This is the only ground of complaint: there is no suggestion that the Internal Revenue Service erred in reducing the basis of some but not all of plaintiff's depreciable property, or more specifically that the Service erred in not reducing the basis of plaintiff's property subject to the retirement-replacement method of depreciation. In our opinion, the allegations in the claim for refund were insufficient to call the Commissioner's attention to the potential ground for recovery now urged upon us, or to state the facts which would enable the Commissioner to discover for himself and correct what is now claimed to be erroneous action.

It is not determinative of the issue, but the fact that this ground for recovery is not mentioned or referred to in plaintiff's petition is an indication that it was not included in the claim for refund.

The reasons for requiring a ground for refund to be raised first before the Internal Revenue Service were explained in *Union Pac. R.R.* v. *United States, supra:*

> It is an undisputed general rule that a ground for refund neither specifically raised by, nor comprised within the general language of, a timely formal or informal application for refund to the Internal Revenue Service cannot be considered by a court in which a suit for refund is subsequently initiated. * * * The rule that a taxpayer cannot present one ground for refund in its claim and a different ground in its petition is designed both to prevent surprise and to give adequate notice to the Service of the nature of the claim and the specific facts upon which it is predicated, thereby permitting an administrative investigation and determination. * * * In addition, the Commissioner is provided with an opportunity to correct any errors, and if disagreement remains, to limit the scope of any ensuing

litigation to those issues which have been examined and which he is willing to defend. * * * (182 Ct. Cl. at 108, 389 F. 2d at 412) [citations omitted]

Therefore, as a result of the omission in plaintiff's refund claim, the claim cannot now be considered.

IV

Plaintiff's Alternative Contention on the Debt Discount Issue

Plaintiff's final argument is that if it should be denied the right to amortize the debt discount it claims with respect to the 1947 and 1956 transactions, it should nevertheless be permitted to add the claimed debt discount to the cost basis of its depreciable property. The entire argument is predicated on the assumption that plaintiff actually incurred debt discount in the transactions mentioned. Since we have held to the contrary, this claim must also be denied.

V

Conclusion

For the reasons stated above, plaintiff's motion for partial summary judgment is denied. Defendant's motion for partial summary judgment is granted, and to the extent that plaintiff's claims are covered by the foregoing opinion, such claims in plaintiff's petitions are hereby dismissed.

APPENDIX E

In the United States Court of Claims

Nos. 142-67 and 95-68

(Decided June 12, 1970)

MISSOURI PACIFIC RAILROAD COMPANY v. THE UNITED STATES

Robert T. Molloy, attorney of record, for plaintiff. *Mark M. Hennelly*, *Gilbert P. Strelinger*, *Gerald J. O'Rourke*, *Jr.*, and *Robert E. Simpson*, of counsel.

E. Alan Moorhouse, with whom was *Assistant Attorney General Johnnie M. Walters*, for defendant. *Ira M. Langer* (Case No. 142-67) and *Philip R. Miller* and *Theodore D. Peyser* (Case No. 95-68), of counsel.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, *Judges*.

ON PLAINTIFF'S MOTION FOR PARTIAL SUMMARY JUDGMENT AND DEFENDANT'S CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT

COLLINS, *Judge*, delivered the opinion of the court:

This is a consolidated action[1] by the Missouri Pacific Railroad Company to recover, in addition to certain other

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[1] This action is a consolidation of case No. 142-67 and case No. 95-68. Plaintiff's claim for debt discount deduction is the same in each case except that No. 142-67 is concerned with the taxable years 1957-58, and No. 95-68 relates to the years 1960-61.

claims,[3] the extra taxes which it had to pay as the result of its failure to receive a debt discount deduction for the years 1957–61. Both parties have filed motions for partial summary judgment in regard to the debt discount issue, so that this is the only issue before the court for consideration at this time.

Just recently in the case of *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. ——, 422 F. 2d 425 (Feb. 1970), this court grappled with the question of whether debt discount amortization would arise in instances where a corporation issued bonds in exchange for its own stock. We held that debt discount was not available in such a situation—especially since the face value of the bonds was equivalent to the amount originally paid for the stock. Our decision in *Erie Lackawanna* was limited just to the facts of that case, and we purposely avoided collateral issues such as whether debt discount would be available where bonds were issued for "other types of property," and whether debt discount would arise when the purchase price of the stock was less than the face value of the bonds. As a result of the instant case, we are now required to expand on our ruling in *Erie Lackawanna* and carry it several steps further.

Plaintiff is a corporation organized and existing under the laws of the State of Missouri and has its principal offices located in St. Louis. At all times pertinent to the issues in question, plaintiff was engaged in the business of operating as a common carrier by rail in interstate commerce subject to the jurisdiction of the Interstate Commerce Commission (ICC). For the taxable years in question, plaintiff was an accrual basis taxpayer and filed its federal income tax returns on the basis of the calendar year. Plaintiff, along with its subsidiaries, was reorganized, effective March 1, 1956, pur-

[3] The other claims which are involved in this action, but which will not be considered at this time are: (1) failure to allow a capital loss on the sale of an office building (No. 95–68); (2) improper treatment of corporate distributions as dividends rather than as a return of capital (Nos. 95–63 and 142–67); (3) failure to use the retirement-betterment method of accounting for the installation of welded track (No. 95–68); and (4) failure to allow plaintiff a foreign tax credit for taxes paid to the Republic of Mexico (Nos. 95–63 and 142–67). Also involved in case No. 142–67 was a dispute over how much tax credit plaintiff was entitled to receive in 1958 under § 1341 of the Int. Rev. Code of 1954 for refunds made to the United States of amounts reported as income under claim of right in prior years. This issue was resolved in favor of plaintiff by this court in the case of *Missouri Pac. R.R.* v. *United States*, 191 Ct. Cl. —— (Mar. 1970).

suant to a plan of reorganization approved by the ICC and the Federal district court [3] having jurisdiction over plaintiff's trusteeship under section 77 of the Federal Bankruptcy Act, 11 U.S.C. § 205 (1964). Under the reorganization plan, plaintiff issued: (1) collateral trust notes, (2) first mortgage 4¼% bonds (series B and C), (3) general mortgage income 4¾% bonds (series A and B), (4) 5% 90-year debentures, and (5) stock [4] in exchange for its own outstanding debt securities and stock and the outstanding debt securities and stock of its subsidiaries. As a result of this reorganization, the subsidiaries were merged into and became a part of plaintiff corporation.

The terms of the exchange varied among the holders of the debt and equity interests of plaintiff and its subsidiaries. For instance, in some cases the bondholders received new debt securities (often in various combinations) equal to the face amount of their old debt with the accrued and unpaid interest being paid in cash. Other bondholders received new debt securities in an amount equal to the sum total of the face amount of their old bonds plus the accrued and unpaid interest. The above-mentioned interest had accrued during the years plaintiff was in the process of reorganizing under section 77 of the Federal Bankruptcy Act. This accrued interest was deducted by plaintiff from its gross income for federal income tax purposes during the years in which it became due. In addition, plaintiff also took deductions for certain amounts of amortized bond discount relating to the old bonds. Once the reorganization became effective, all unamortized discount on the old securities was carried forward and amortized during the life of the new securities. [5]

Plaintiff's claim in this case is premised upon the fact that the aggregate maturity value of the new bonds issued pursuant to the reorganization plan was greater than the value

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[3] The plan was approved on March 1, 1956, by the United States District Court for the Eastern District of Missouri by Order No. 4710A.

[4] For purposes of the debt discount issue in this case, the value of the new stock issued as part of the reorganization will not be included in the total amount of property given up by plaintiff. Thus, the stock figures and any reference thereto will be eliminated from consideration for purposes of this decision.

[5] *See, e.g., Chicago, M., St. P. & Pac. R.R.* v. *United States*, 166 Ct. Cl. 250, 404 F. 2d 960 (1968), where this court gave its approval to the idea of carrying forward old discount and amortizing it along with new discount over the life of the new bonds.

of the securities received in exchange, as determined by New York Stock Exchange price quotations. Plaintiff alleges that the aggregate maturity value of the new bonds was $529,117,141, while the fair market value of the old securities given in exchange was determined to be $452,151,252. The difference of $76,965,889 is the amount which plaintiff claims represents the debt discount deduction which must be amortized over the life of the bonds in question. Treas. Reg. § 1.163-3(a)(1), T.D. 6984, 33 Fed. Reg. 19175 (1968); *Helvering* v. *Union Pac. R.R.*, 293 U.S. 282 (1934); *Pierce Oil Corp.* v. *Commissioner*, 32 B.T.A. 403 (1935). Specifically, the instant case is concerned with the taxable years 1957–61. For each of these 5 years, plaintiff asserts that it was entitled to an amortization deduction in the amounts of $1,027,372 in 1957, $1,023,325 in 1958, $1,018,760 in 1959, $1,019,453 in 1960, and $905,650 in 1961. Thus, these are the amounts which form the basis for plaintiff's claim of recovery.[6]

The difference between this case and *Erie Lackawanna* is that, in the latter, debt securities were exchanged for the company's *own stock*. In this case, debt securities of the reorganized and consolidated company were exchanged for the company's *own bonds* and the *stocks and bonds of its subsidiary companies*. Consequently, the question now confronting the court is whether the rule of *Erie Lackawanna* should be extended to cover the types of securities just mentioned, or whether plaintiff's own bonds and the securities of its subsidiaries should be included in a category different from its own stock. Plaintiff urges that the old securities involved in this case should come under the heading of "other types of property," different from a corporation's own stock, and thus should be treated differently. Defendant argues that there is no real difference between a situation where a corporation exchanges debt securities for its own stock and where it exchanges debt securities for the stocks and bonds of its subsidiaries. For reasons to be hereinafter stated we agree basically with the arguments of defendant and render our decision in accordance therewith.

The basis of our decision in *Erie Lackawanna* was that when a corporation exchanged $100 face value bonds for its

[6] The above-mentioned facts have all been agreed to by stipulation of the parties.

own stock for which it had received $100, then it had really lost nothing as a result of the transaction. Plaintiff has tried to argue that we are not concerned with gains or losses (which involve a tax basis problem under sections 1012 and 165 of the Internal Revenue Code of 1954), but rather we are concerned with interest or "compensation for the use or forbearance of money" under section 163. *Deputy* v. *DuPont*, 308 U.S. 488, 498 (1940). We agree that debt discount is normally treated as interest under section 163, but we should point out that in some cases a debt discount deduction has been taken under section 165 which is the loss provision. *E.g.*, *Dodge Bros.* v. *United States*, 118 F. 2d 95 (4th Cir. 1941); *Atlanta & Charlotte Air Line Ry.* v. *Commissioner*, 36 B.T.A. 558 (1937). The distinction, however, is somewhat irrelevant since the amount of the deduction would be the same under either section. Therefore, for purposes of this case, we will accept plaintiff's approach and treat the debt discount as interest, deductible under section 163.

In essence, what this court was saying in *Erie Lackawanna* was that, in the exchange of bonds for stock, there was no difference in the values of what was given up and what was received. In other words, there was an exchange of equals, so that when the transaction was completed the corporation's financial situation had simply been rearranged, but it had not really been changed. The corporation had not obligated itself to pay out any more than it had already received. Consequently, we held in *Erie Lackawanna* that there was no amount which could be treated as interest and deducted as a debt discount. We now find that we are faced with basically the same type of situation as existed in *Erie Lackawanna*.

The main difference between the approach taken by this court in *Erie Lackawanna* (which will be followed today in this case) and that urged by plaintiff in this case is over the method of evaluating the property received for the new bonds. Plaintiff would have us determine the value of the securities received by it in exchange for its new bonds through the use of fair market value as determined by New York Stock Exchange price quotations. Just as we could not accept this method of valuation in *Erie Lackawanna*, where a corporation's own stocks were involved, so also we

cannot accept this method where a corporation's own bonds are involved. Fair market value is meaningless when attached to a piece of property which will no longer be subject to market conditions. It cannot be of any real significance in a situation such as this where plaintiff's old securities were immediately destroyed upon redemption. Instead, the face value of plaintiff's old bonds at the time of their issuance is the true valuation of these securities *as far as plaintiff is concerned. See Union Pac. R.R.* v. *United States*, 185 Ct. Cl. 393, 401 F. 2d 778 (1968), *cert. denied*, 395 U.S. 944 (1969). The fact that the fair market value of the old bonds may be less than the face value of the new bonds can in no way reduce the amount of value originally paid to plaintiff for the old securities. Consequently, for the court to say that plaintiff is entitled to a debt discount deduction because the fair market value of the old bonds is less than the maturity value of the new bonds is to give credence to an illusional or fictional interest charge which does not actually exist. For this reason, we cannot adopt plaintiff's method of valuation.

In addition, if we were to employ plaintiff's system of determining debt discount through the use of fair market value, it would appear that plaintiff would be unjustly increasing the amount of its deductions without correspondingly increasing its obligations. We have already conceded that plaintiff is entitled to carry over the discount from the old bonds. To then say that plaintiff is entitled to further discount as the result of the old bonds having a fair market value less than the face value of the new bonds would result in allowing plaintiff to increase the amount of its discount simply by substituting new obligations for old. We do not feel that a corporation should be allowed to increase the amount of its allowable deductions in such a manner, unless there truly is an increase in its bond indebtedness. Plaintiff has not been able to show that there is such an increase in this case.

We stated in *Erie Lackawanna* that, in the bond discount area, a corporation's own stock (and we have expanded this to include a corporation's own bonds by this case) comprises a category completely separate from cash and other types of property. The reason for this categorization should now be obvious. If plaintiff exchanged its bonds for some tangible

property such as the inventory of a corporation or even for the securities of another corporation, it would be understandable to value this property, for purposes of determining debt discount, through the use of fair market value.[7] However, there is a great deal of difference between this situation and one where a corporation receives its own stocks and bonds. Fair market value in the latter instance just does not have the same significance nor does it create the same result as in the former.

Having rejected plaintiff's method of computing debt discount through the use of fair market value and having placed a corporation's own bonds in the same category as its own stock, it now becomes necessary to determine how the stocks and bonds of a corporation's subsidiary should be categorized. Plaintiff would have us follow the reasoning of the United States Court of Appeals for the Third Circuit in *American Smelting & Ref. Co.* v. *United States*, 130 F. 2d 883 (3d Cir. 1942). In that case, the court ruled first that debt discount amortization would be available where stock of a subsidiary corporation was used as payment for the issuance of new

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[7] We do not mean to imply by this statement that we are now holding that debt discount is available where bonds are issued for property (other than the corporation's own securities). In fact, there appears to be a definite split of authority on this question with *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39 (2d Cir. 1962), and *American Smelting & Ref. Co.* v. *United States*, 130 F. 2d 883 (3d Cir. 1942), holding that debt discount is available where bonds are issued for property, and *Southern Natural Gas Co.* v. *United States*, 188 Ct. Cl. 302, 413 F. 2d 1222 (1969), *Montana Power Co.* v. *United States*, 141 Ct. Cl. 620, 160 F. Supp. 892, *cert. denied*, 358 U.S. 842 (1958), and *Montana Power Co.* v. *United States*, 222 F. 2d 541 (3d Cir.), *cert. denied*, 382 U.S. 943 (1956) (dictum), stating that debt discount is not so available. We are simply saying that, as between the situation where a corporation issues bonds for its own securities and where a corporation issues bonds for other types of property, we can better understand how fair market value could be applied to the latter situation but not to the former—assuming, for the moment, that debt discount would be available in the latter situation.

It should be pointed out that this problem may not arise in the future because of the Tax Reform Act of 1969, 83 Stat. 487. Both the House and Senate Reports have indicated that there may be original issue discount when a corporation issues a bond for a price less than its face value whether it receives cash, stock, *or other property* (including the assets of another corporation). Also, in a case where a bond is issued for property, it is provided that the issue price of the bond will be the fair market value of the property. S. Rep. No. 91-552, 91st Cong., 1st Sess. 148 (1969); H.R. Rep. No. 91-413 (Part I), 91st Cong., 1st Sess. 110 (1969).

We do not feel that such a provision would be detrimental to our decision in this case, especially in light of a Senate amendment which now provides that the issue price of bonds issued in reorganizations shall be the stated redemption price at maturity, Tax Reform Act of 1969, 26 U.S.C.A. § 1232(b) (1970).

debt securities by the parent. In addition, the court held that the cost of the debt securities should be determined by reference to the fair market value of the stock at the time of the exchange. Thus, once again, plaintiff would have us regard the securities of a subsidiary as property which should be treated differently from a corporation's own stock, and it also urges us once more to use fair market value as the means of determining valuation. However, we are unable to accept these arguments by plaintiff just as we are unable to accept the decision of the Third Circuit in *American Smelting & Ref. Co.* v. *United States*, *supra*.[8]

In the situation which exists in this case, where, prior to the reorganization, the subsidiaries involved were wholly owned,[9] there is no real difference between an exchange by a corporation of bonds for its own securities and those of its subsidiaries. The same general rule applies, namely, that the true value of the stocks and bonds *in the eyes of the corporation* is the original value of the securities, which value becomes a part of the assets of the parent corporation as the result of the reorganization and merger. Once again, to try and say that the cost of the new bonds is the fair market value of the old securities, at the time of the exchange, would be to create an interest charge that does not exist since the effect on the capital structure of the corporation would be the same regardless of the fair market value of the old securities. Consequently, we conclude that the securities of the subsidiaries involved in this case[10] should be treated the same as the securities of plaintiff corporation.

One point which we purposely failed to consider in *Erie Lackawanna* was whether debt discount would arise in a

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[8] This court has on two occasions specifically rejected the decision in *American Smelting & Ref. Co.* v. *United States*, *supra*—once in *Southern Natural Gas Co.* v. *United States*, *supra*, and again in *Montana Power Co.* v. *United States*, 141 Ct. Cl. 620, 159 F. Supp. 593, *cert. denied*, 358 U.S. 842 (1958).

[9] The two main subsidiaries involved in this case were New Orleans, Texas & Mexico Railway Company and International-Great Northern Railroad Company. Plaintiff owned approximately 94% of the common stock and all the preferred stock of New Orleans. (The remaining 6% was publicly owned.) New Orleans owned all the stock of International.

[10] The securities of the subsidiaries which are involved in this case are: New Orleans first mortgage bonds (series A–D), New Orleans common stock, International first mortgage bonds (series A–C), and International adjustment mortgage 6% bonds.

situation where the amount paid for the stock was less than the maturity value of the bonds. The corresponding issue in this case is whether debt discount will arise if the value of the old bonds is less than the value of the new bonds.

In examining the majority of the exchanges which took place as a part of the reorganization, it would appear that it would again be unnecessary to determine the answer to the above-stated issue. This is because in most of the transactions there was an exchange of items of equal value. For instance, in the exchange of new first mortgage 4¼% bonds (series B and C) for old Missouri Pacific first and refunding mortgage 5% bonds, and in the exchange of new collateral trust notes for old New Orleans, Texas & Mexico Railway Company first mortgage bonds (series A–D), there was an exchange of equal values of old and new bonds—with the accrued interest being paid separately in cash. In the rest of the transactions (except for two), there was an exchange of new bonds for old bonds to the extent that the value of the new bonds equaled the value of the old bonds plus accrued interest. Thus, again there was an exchange of equals, except this time plaintiff received an old bond plus a cancellation of interest indebtedness which together equaled the value of the new bond. In both types of transactions, plaintiff was receiving the equivalent of what it was giving up, so that there was nothing which could be deducted as interest.

However, based on the figures presented in the record, there appear to be two instances in which the exchange of bonds for securities was not equal. This occurred in the exchange of new first mortgage 4¼% bonds (series C) and general mortgage 4¾% income bonds (series A and B) for the publicly held common stock of New Orleans, Texas & Mexico Railway Company. The other instance involved the exchange of new first mortgage 4¼% bonds (series B and C) for old Little Rock & Hot Springs Western Railroad Company first mortgage 4% bonds. Assuming that the figures which we now have are correct, which indicate that there is a difference between the value of the new bonds and the amount received in exchange therefor, it becomes necessary to decide whether this difference should give rise to a

discount in light of the fact that this exchange was part of a corporate reorganization.

There is some authority to the effect that where there is a difference between the maturity value of the bonds and the amount received in exchange, and this takes place during a reorganization, then this difference should not be treated as debt discount. *Montana Power Co.* v. *United States*, 232 F. 2d 541, 549–50 (3d Cir.), *cert. denied*, 352 U.S. 843 (1956) (dictum); *New York, C. & St. L. R.R.* v. *Commissioner*, 23 B.T.A. 177 (1931); Rev. Rul. 59–387, 1959–2 Cum. Bull. 56. In the revenue ruling, the Commissioner of Internal Revenue held that where there was an issuance of 30-year debentures by a corporation for its own preferred stock, this was simply a recapitalization, and the preferred stock could not be recognized as assets in the hands of the corporation. Thus, considering the character of the exchange, the Commissioner did not feel that there was bond discount in the true meaning of the term. In *Montana Power Co.* v. *United States*, *supra*, three of the seven judges, in a dicta portion of the opinion, stated that an underlying theory of bond discount is that the transaction must be negotiated in the open market and at arm's length. They did not feel that such elements were present in a tax-free corporate reorganization.

Despite this authority, which is not exactly overwhelming in its strength or particularly persuasive in its approach, we find that bond discount can arise where there is a difference between what is given up and what is received, and this can occur in connection with a corporate reorganization. The fact that there is a difference in value between the bonds being issued and the securities being given up is enough to invoke the debt discount provision. The ultimate result of this difference is that the corporation is obligating itself to pay a debt which is greater in value than that which it is receiving. It seems irrelevant that what the corporation is receiving is its own securities, or that they will be destroyed because, in essence, these securities still have a value with the corporation, namely, their original cost. This original cost is still a part of the corporate assets and thus should be considered as the

actual amount paid for the issuance of the new bonds. Consequently, any difference between this amount and the maturity value of the bonds should be treated as a discount and amortized over the life of the bonds.

To summarize the conclusions of the court in this case, we hold:

(1) That for purposes of determining debt discount, the debt securities and stock of a corporation and the debt securities and stock of a corporation's wholly owned subsidiary, which are given up for a corporation's new bonds, should be treated alike.

(2) That when exchanged for new bonds, the above-mentioned securities should not be evaluated by the use of fair market value. Instead, the stocks should be given a value equal to the amount originally paid for them, and the value of the bonds should be determined by their maturity value as of the time of issue.

(3) That debt discount is available where the value of the stocks or bonds, as determined in item (2) above, is less than the maturity value of the debt securities for which they are exchanged.

Applying these rules, we find that, in the present case, there was no debt discount available in any of the exchanges which were a part of the reorganization—except possibly in two of the transactions. In regard to these two transactions, which involve the publicly held common stock of New Orleans, Texas & Mexico Railway Company and the bonds of Little Rock & Hot Springs Western Railroad Company, we do not have sufficient information to make a final decision. The record indicates neither the amount originally paid for the common stock,[11] nor the exact figures of the Little Rock transfer—especially the amount of accrued interest involved, if

[11] In a letter to Mr. Roswell Magill from Mr. H. T. Swarts, Director, Tax Rulings Division, dated March 13, 1956, New Orleans, Texas & Mexico Railway Company was listed as having 148,329 shares of outstanding common stock at $100 par value. The schedule referred to in finding 8 of *Missouri Pac. R.R. v. United States*, 167 Ct. Cl. 725, 736, 337 F. 2d 637 (1964), lists the principal amount of this publicly held common stock to be $859,800. We are not certain whether either figure has any relation to the amount actually paid for the stock.

any.[13] As a result, we are remanding the case to the trial commissioner in order that he might compel the production of the data necessary to reach a final determination in regard to these two transactions. If the commissioner should find that there is a difference in value between the new Missouri Pacific bonds and the old securities given in exchange therefor, plaintiff will be entitled to a debt discount deduction in an amount which will be determined by the commissioner. If no such difference is discovered, then plaintiff will not be entitled to any discount deduction. In either case, unless the parties hereto stipulate in the interest of time, the commissioner shall report his findings to the court for final determination and judgment.

[13] There is quite a discrepancy between the figures in plaintiff's schedule A, attached to the order of the district court, and the schedule in *Missouri Pac. R.R.* v. *United States*, *supra*, relating to the exchange of Little Rock & Hot Springs Western Railroad Company first mortgage 4% bonds for Missouri Pacific Railroad Company first mortgage 4½% bonds (series B and C). In plaintiff's schedule A, $1,519,346 worth of new bonds were exchanged for $1,140,000 worth of old bonds (as listed in the March 13th letter to Mr. Magill, note 11 *supra*). However, in the schedule in the *Missouri Pacific* case, $1,344,582 worth of new bonds were exchanged for a similar amount of Little Rock bonds. Because of this discrepancy, we feel the transaction should be examined by the commissioner.

In the United States Court of Claims

Nos. 142-67 and 95-68

(Decided November 13, 1970)

MISSOURI PACIFIC RAILROAD COMPANY v. THE UNITED STATES

Robert T. Molloy, attorney of record, for plaintiff.

E. Alan Moorhouse, with whom was *Assistant Attorney General Johnnie M. Walters*, for defendant. *Philip R. Miller* and *Theodore D. Peyser*, of counsel.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, COLLINS, SKELTON, and NICHOLS, *Judges*.

ON DEFENDANT'S MOTION FOR REHEARING OR RECONSIDERATION

PER CURIAM: Defendant has asked us to reconsider part of our holding in this case. 192 Ct. Cl. ——, 427 F. 2d 727 (June 12, 1970).[1] The objection is to the conclusion, in our original opinion, that, when new bonds are issued for old stocks, debt discount is available where the amount originally paid for the old stocks is less than the maturity value of the new debt securities for which they are exchanged. We applied that rule to the publicly held common stock of New Orleans, Texas & Mexico Railway Company, and remanded the case to the trial commissioner to determine the amount originally paid by the taxpayer-plaintiff for that stock. The Government urges that this rule is not appropriate for an exchange of new bonds for old stock.

[1] Plaintiff has also filed a motion for reconsideration which is being denied today, by order without opinion.

Since our original opinion, a helpful decision has been rendered on this very point in the Southern District of New York. *Cities Service Co.* v. *United States*, 26 AFTR2d ¶ 70-5100, p. 70-5378 (July 24, 1970). Judge Mansfield there points out (26 AFTR2d at 70-5385) that the basic principle for the allowance of debt discount is that a "true loss", i.e., a detriment, must be sustained by a taxpayer issuing obligations payable at their face value at some future date, and that, if in fact the taxpayer receives a lesser consideration upon issuance than it will have to return at maturity, the difference is normally considered a debt discount in the absence of circumstances indicating otherwise. That is the general principle we followed in *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. 682, 422 F. 2d 425 (1970), and endeavored to apply in our opinion in the present case.

With respect to the particular problem of debt obligations exchanged for stock, the *Cities Service* opinion holds (26 AFTR2d at 70-5387) that the *minimum* amount the taxpayer may ascribe to the shares acquired by it for the new debt obligation is the original consideration, and "even if the market value of the shares at the time of the exchange had declined below their original issue price [taxpayer], would be precluded from claiming the decline in value as a loss because, having received the cost price upon issuance of the shares, it had not actually suffered a loss to the extent of the market decline." With this statement, we agree, of course.

The District Court then goes on to hold (26 AFTR2d at 70-5387), contrary to our original opinion in this case, that the original issue or cost price of the exchanged shares did not represent the ceiling value of the stock for the purpose of calculating debt discount. Its reasoning is that at the time of the exchange the shares could have a greater value to the taxpayer than the original issue or cost price. "Thus, where a taxpayer receives its own shares in exchange for issuance of its debentures, the value of 'what is received' for the purposes of determining the deductible loss or discount may be higher (though not lower) than the original issue price of the shares. The actual value to the taxpayer can be determined only after consideration of all relevant data, including the

market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects, and expert opinion."[3]

On reconsideration, persuaded by this *Cities Service* discussion, we hold that, with respect to shares of its own stock or stock in its subsidiaries, the present taxpayer cannot calculate, for debt discount purposes, the value of the stock at its cost or issuance price. That figure can be the floor but it cannot be the ceiling. The correct measure is the value of the New Orleans stock to plaintiff at the time of the exchange of the bonds for that stock.

In this instance, however, we need not order a trial to determine that value.[4] That determination has already been made. In taxpayer's reorganization proceedings, the value of the New Orleans stock was extensively canvassed before the Interstate Commerce Commission and the courts. See *Missouri Pac. R.R. Reorganization*, 275 I.C.C. 59, 113, 125–27 (1949); 290 I.C.C. 674, 678–79 (1954); *In re Missouri Pacific R.R.*, 93 F. Supp. 832, 848–49 (E.D. Mo., 1950), 129 F. Supp. 392, 399 (E.D. Mo. 1955); *State of Texas* v. *Group of Institutional Investors*, 191 F. 2d 265, 273–74 (8th Cir. 1951) *cert. denied*, 342 U.S. 904 (1952); *Missouri Pacific R.R. 5¼% S.S.B.C.* v. *Thompson*, 229 F. 2d 898, 900–01 (8th Cir. 1956). The final reorganization plan, which was confirmed and adopted, found the stock to be then worth $250 per share, but only $216 in maturity value of the bonds was allocated to each share, as the "equitable equivalent" of the $250 value. *Missouri Pac. R.R. Reorganization*, *supra*, 290 I.C.C. at 678–79. Thus, the value of the New Orleans stock, at the time of the exchange, has authoritatively been found, after considerable and careful inquiry (including expert testimony), to be not less than the maturity value of the bonds exchanged. *Cf. Arkansas-Missouri Power Corp.* v. *Paschal*, 243 F. 2d 584, 588 (8th Cir), *cert denied*, 355 U.S. 835 (1957).

The fact that the stock was selling for less on the stock exchange is not at all conclusive (*Cities Service Co.* v. *United States*, *supra*, 26 AFTR2d at 70–5387), and in this case is

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[3] The opinion emphasizes that the market price would be relevant but not conclusive, and that the significant figure is that "representing the value to plaintiff [the taxpayer] of the shares in question."

[4] In *Cities Service*, a trial was directed.

clearly outweighed by the other factors which led the Interstate Commerce Commission and the federal court to find and determine that the new bonds were a "fair and equitable" equivalent for the New Orleans stock. There was, therefore, no debt discount on the issuance of the bonds since the plaintiff-taxpayer received at least the equivalent (in stock value) of the maturity value of the bonds.

This conclusion calls for a modification of our prior holding and opinion. The exchange involving the New Orleans stock falls into the same category as the majority of the transactions dealt with in that opinion—there was no debt discount on the transaction—and there is no need for a remand. The remand ordered in our prior opinion is, accordingly, restricted to the transaction involving the Little Rock bonds. In addition, the last portion of our prior opinion, 192 Ct. Cl. ——, ——, 427 F. 2d at 739–34,[4] is modified to refer only to bonds and other debt obligations, not to stock, insofar as the holding is that the original value of the securities must be looked to for the purpose of determining whether a bond discount exists. The few references in that opinion to the original cost of shares of stock as determinative are stricken and replaced by the standard of the actual value of the stock to the taxpayer at the time of the exchange. It goes without saying that, with respect to bonds exchanged for bonds, the opinion still stands as written.

To the extent indicated in this opinion the defendant's motion for rehearing or reconsideration is granted and our prior decision and opinion are modified.

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[4] Beginning with the sentence (slip op., p. 8), "The same general rule applies, namely, that the true value of the stocks and bonds in the eyes of the corporation is the original value of the securities, which value becomes a part of the assets of the parent corporation as the result of the reorganization and merger," and continuing through to the end of the opinion.

U.S. GOVERNMENT PRINTING OFFICE: 1970

APPENDIX F

* * *

[¶ 9305] Gulf, Mobile and Ohio Railroad Company, Plaintiff v. United States of America, Defendant. Gulf, Mobile and Ohio Railroad Company, Plaintiff v. United States of America, Defendant.

U. S. District Court, So. Dist. Ala., So. Div., Civil Action Nos. 5662-69, 6332-70, 2/18/72.—(339 F. Supp. 489.)

[Code Secs. 61 and 163]

Deduction: Bond issue discount expense: Interest: Bonds exchanged for preferred stock: Bond discount determined.—The corporate taxpayer was entitled to amortize bond discount over the life of the bonds that arose on the exchange of bonds for the corporation's outstanding preferred stock. However, the amortization deduction could not be based on the amount of discount that was determined by subtracting the total market value of the preferred stock, as determined by the listed price on the New York Stock Exchange, from the principal amount of the bonds issued. Rather, the discount on which the amortization had to be based was (1) the difference between the issue price originally received by the taxpayer for the preferred stock and the par value of the bonds, or (2) the difference between the fair market value of the preferred stock and the par value of the bonds if the taxpayer was able to show that the fair market value of the stock at the time of the exchange was greater than the issue price. The court ruled, however, that no bond discount would exist if either the issue price of, or the fair market value of, the preferred stock exceeded the par value of the bonds. Back references: ¶ 674.1326 and 1416.05.

J. N. Ogden, W. H. Sanders, P. O. Box 1828, Mobile, Ala., W. A. Kimbrough, P. O. Box 5583, Mobile, Ala., for plaintiff. C. S. White-Spunner, Jr., P. O. Drawer E, Mobile, Ala., Donald B. Craven, Department of Justice, Washington, D. C. 20530, for defendants.

Order

PITTMAN, District Judge: This case is now submitted upon defendant's Motion For Partial Summary Judgment and plaintiff's Cross Motion For Partial Summary Judgment.

This court has jurisdiction in this matter pursuant to Section 1346(a)(1) of Title 28 of the United States Code.

On November 8, 1957, and supplemented on November 19, 1957, the plaintiff, Gulf, Mobile and Ohio Railroad Company (here-

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inafter referred to as "taxpayer") applied to the Interstate Commerce Commission (ICC) for authority to issue five-percent income debentures, Series A, due December 1, 2056, in principal amount not to exceed $28,343,800. The income debentures were to be exchanged on a voluntary basis for up to 283,438¼ shares of taxpayer's issued and outstanding preferred stock, without par value, $5 Series, with a stated value of $100 per share. The terms of the exchange were one Series A income debenture in principal amount of $100 for one share of preferred stock.

The interest on the income debenture was payable currently, only if earned, and cumulative interest was limited to 15 percent. The preferred stock was without par value and carried a stated value of $100. Dividends on the preferred were payable at the rate of $5 per share per annum when and as declared by the board of directors and were cumulative, subject, however, to certain limitations. The stock was callable at its stated value plus any accumulated and accrued dividends. It was carried on taxpayer's balance sheet at its stated value of $100 per share. At all times here relevant, the preferred stock and income debentures were listed and traded on the New York Stock Exchange. At the date of the exchange the market price for the preferred shares was less than the principal amount of the debentures.

On December 20, 1956, the Interstate Commerce Commission granted plaintiff the authority to issue the income debentures. Pursuant to that order, taxpayer, during the period December 31, 1957, through December 31, 1962, issued a total of 187,116 income debentures in exchange for a like number of shares of preferred stock.[1] The total exchange resulted in a debit of $18,711,600 to the preferred stock account and a corresponding credit to the income debentures account in the same amount.

[Amount of Discount]

Subsequently, taxpayer filed claims for refund with respect to its taxable years ended December 31, 1959 and 1961, in which it claimed a refund of taxes based on, among other things, a deduction for amortizable bond discount arising from the exchange of the above debentures. The deduction was computed by taking the total principal amount ($18,711,600) of debentures issued and subtracting therefrom the total market value ($11,869,092.44) of the preferred stock, as determined by the listed price on the New York Stock Exchange. The result, $6,842,507.56 was determined by taxpayer to be the total discount arising from the exchange, which amount was claimed to be amortizable over the life of the debentures. Upon disallowance of these claims, these actions were timely commenced.

The crux of the problem in these cases dealing with bond discount is that there is no statutory treatment of the subject. Section 163 of the Internal Revenue Code of 1954 allows corporations and individuals to deduct all interest paid or accrued within the taxable year. This has been supplemented by Internal Revenue Regulation 1.163-3(a) which provides:

> "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond."

It is agreed by the parties that if the bonds had been issued for cash in the amount of the selling price of the preferred stock at the time of the exchange, the discount would be proper and the amortization deduction allowed. Taxpayer contends that the bonds-for-stock situation presented here should be treated the same as bonds-for-cash. The argument is that there is no basis in economic reality for differentiating between the two transactions. Also, it is pointed out that the same result could have been accomplished in a two-step exchange (bonds for cash; cash for preferred stock) which arguably would have escaped the challenge encountered here. The Government maintains that the bonds-for-stock exchange is an entirely different event than one involving cash and should meet with a different result. The transaction is characterized as a recapitalization within the meaning of Section 368(a)(1)(E) of the Internal

[1] The amounts of the exchanges were:
1957—$95,200 in principal amount of income debentures for 852 shares.
1958—$12,653,000 in principal amount of income debentures for 126,530 shares.
1959—$337,800 in principal amount of income debentures for 3,378 shares.
1960—$1,046,300 in principal amount of income debentures for 10,463 shares.
1961—$3,767,300 in principal amount of income debentures for 3,673 shares.
1962—$822,000 in principal amount of income debentures for 8,220 shares.

Revenue Code of 1954 with the result being a mere reshuffling of the capital structure with no new capital added. The fact that taxpayer's preferred stock account was debited $100 for each share of stock taken in, and the income debenture account credited $100 for each bond that was issued, is cited as proof of the "reshuffling" aspect of the exchange.

In deciding this issue, the court is faced with an apparent conflict of authority. Taxpayer relies upon decisions from the Second, Third, and Tenth Circuits as well as several District Court cases. *Atchison, Topeka & Santa Fe Railroad Co. v. United States*, 71-1 USTC ¶ 9430 (10th Cir. 1971); *Nassau Lens Co. v. Commissioner* [62-2 USTC ¶ 9723], 308 F. 2d 39 (2nd Cir. 1962); *Montana Power Co. v. United States* [56-1 USTC ¶ 9402], 232 F. 2d 541 (3rd Cir. 1956); *American Smelting & Ref. Co. v. United States* [42-2 USTC ¶ 9670], 130 F. 2d 883 (3rd Cir. 1942); *Claussen's Inc. v. United States*, 71-2 USTC ¶ 9632 (S. D. Ga. July 29, 1971); *Cities Service Co. v. United States* [70-2 USTC ¶ 9537], 316 F. Supp. 61 (S. D. N. Y. 1970), reaff'd 71-2 USTC ¶ 9501 (1971); *Industrial Dev. Corp. v. United States* [56-2 USTC ¶ 10,066], 51 A. F. T. R. 1514 (N. D. Ill. 1956); *Southern Fertilizer & Chem. Co. v. Edwards* [55-1 USTC ¶ 49,133], 167 F. Supp. 879 (M. D. Ga. 1955).

The Government places its emphasis on a line of Court of Claims decisions and a recent Tax Court case. *St. Louis-San Francisco Ry. Co. v. United States* [71-2 USTC ¶ 9544], 28 A. F. T. R. 2d 5243 (Ct. Cl. July 14, 1971); *Missouri Pacific Ry. Co. v. United States* [70-2 USTC ¶ 9698], 433 F. 2d 1324 (Ct. Cl. 1970); *Erie Lackawanna Ry. Co. v. United States* [70-1 USTC ¶ 9245], 422 F. 2d 425 (Ct. Cl. 1970); *Southern Natural Gas Co. v. United States* [69-2 USTC ¶ 9473], 412 F. 2d 1222 (Ct. Cl. 1969); *Montana Power Co. v. United States* [58-1 USTC ¶ 9332], 159 F. Supp. 593 (Ct. Cl. 1958), cert. denied 358 U. S. 842 (1958); *National Alfalfa Dehydrating and Milling Co. v. Commissioner* [CCH Dec. 31,030], 57 T. C. 46, 40 L. W. 2247 (Tax Ct. Oct. 14, 1971). A discussion of all the cases in chronological order is thought to be helpful in determining the progression of thinking in the area.

[*Bonds-for-Stock Cases*]

American Smelting & Ref. Co. v. United States, supra, was the first definitive holding that an amortization deduction may arise in a case where bonds are issued for property. The Third Circuit allowed as additional interest deductions bond discount measured by the difference between the maturity value of the bonds and the market value of the preferred stock which had been received. The facts of the exchange were similar to these[3] except that the taxpayer received not its own shares in return for the bonds, but those of a wholly owned subsidiary. The court refused to make the dividing line for bond discount whether the bonds were exchanged for cash or whether they were exchanged for something else. While recognizing "the possibilities of great difficulty in determining with sufficient exactness the difference between the par value of the bonds and the thing other than cash received for the bonds by the obligor," 130 F. 2d at 886, the majority determined that in the case before them, the cost of the bonds was the fair market value of the stock at the time the corporate obligations were exchanged. Taxpayer's proof of the fair market value consisted of the selling price of the preferred stock on the New York Stock Exchange at the time of the exchange and immediately thereafter. Thus, market price was deemed to be sufficient to establish the value of the stock. The dissenting judge disagreed on this point while implicitly concurring with the proposition that bonds-for-stock exchanges could give rise to bond discount if the proof of value was sufficient.

Although *American Smelting* was not cited, the same result was reached in *Southern Fertilizer & Chem. Co. v. Edwards, supra*, one of the two decisions on the issue by District Courts within the Fifth Circuit.[4] Amortization of bond discount was allowed upon a finding that "the evidence amply supports plaintiff's contention that its debenture bonds were issued for a consideration of not more than $75 per $100 face amount of bonds." 167 F. Supp. at 881. However, the issue of proof, regarded as so important in *American Smelting* was not considered because the bonds were stipulated to be worth only 75% of face amount

[3] Taxpayer sought to amortize discount which it claimed had been incurred upon the exchange in 1917 of its 30-year, $100, 5% bonds for 5% and 6% preferred stock of a wholly owned subsidiary corporation with a par value of $100 per share.

[4] Taxpayer issued cash, noncumulative, preferred stock, scrip and its own debenture bond for each share of its 8% cumulative preferred stock in accordance with a negotiated plan of recapitalization. The debenture bonds issued had a par value of $100 and a market value of $75 per share.

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The situation where debentures are issued in exchange for the taxpayer's own stock was also considered in *Industrial Dev. Corp. v. United States, supra.*[4] The District Court for the Northern District of Illinois held that the taxpayer's right to bond discount was unaffected by what was received in return. Discount was based on the difference between the face value of the debentures and the market value of the preferred stock. The court ruled that the fact that the debentures were issued in connection with a tax-free recapitalization did not negate bond discount. Once again, *American Smelting* was not cited and the findings of fact and conclusions of law were made with little discussion.

[Bonds for Property]

The Third Circuit, in *Montana Power Co. v. United States, supra,* reaffirmed its ruling in *American Smelting* on its facts. No bond discount was allowed in a bonds-for-property transaction[5] on the basis that the taxpayer had failed to introduce any evidence of the fair market value of the property received. This appears to be consistent with the *American Smelting* holding that the taxpayer bears the burden of establishing the fair market value of that for which the bonds were issued. However, in dicta, the court refused to follow *American Smelting* in the situation of a bonds-for-property exchange. In discussing *American Smelting,* the court stated:

"It is true in commenting on the government's contention [in the *American Smelting* case] we stated that 'we do not think . . . that the question whether amortization is permitted is settled by making the dividing line between transactions in which bonds are issued for cash and transaction where bonds are issued for something else' but that comment must be considered in the light of the specific question presented for determination. The 'something else' in that case was 'preferred stock' of a wholly-owned subsidiary which the taxpayer received in a recasting of its corporate structure—the issuance of bonds for preferred stock there was in substance a 'funding operation' in which the taxpayer substituted for its preferred stock liability its bond liability. There was not in that case the issuance of bonds and attending creation of a liability in a purchase transaction for investment purposes as was true in this case. The *American Smelting* decision in that respect must be limited to its facts." 232 F. 2d at 546.

Thus, the court appears to have accepted the bonds-for-stock rationale of *American Smelting,* but refused to extend it to an exchange in which property is received.

The Court of Claims also had occasion to consider a claim for bond discount in a bonds-for-property exchange in *Montana Power Co. v. United States, supra.* In that case, the taxpayer issued 30-year debentures for which it received property valued at less than the face amount of the debentures. The corporation retired the debentures at face amount before the thirty-year period and attempted to calculate bond discount as the difference between the principal amount of the debentures and the basis of the assets it had received in exchange. The court sustained the disallowance of the deduction, holding that, as long as the property received for the securities is held, no "loss" can properly be considered as having occurred. Thus, no tax consequences can arise until the gain or loss is realized by a sale of the property. Unanswered was the question of what the tax consequences would be at the time of the sale of the property. The Court of Claims, like the Third Circuit itself, refused to give credence to *American Smelting* in the area of bonds-for-property exchange. The court did not consider a bonds-for-stock exchange and did not address itself to the issue of whether a retirement of the taxpayer's stock upon its receipt would constitute a "realization" for tax purposes.

The time element of realization was also an important factor when the Second Circuit considered bond discount in a bonds-for-property transaction in *Nassau Lens v. Commissioner, supra.*[6] The court, faced with the contention that bond discount is never

[4] The exchange of $140 of debentures plus $10 cash for each share of preferred stock was made pursuant to a plan of statutory merger of taxpayer and a subsidiary corporation. The preferred stock had a par value of $100 per share and a fair market value of $106 per share, at the time of the exchange. The stock carried cumulative dividends at the rate of, but not required to be, $7 per share per annum, payable when declared.

[5] Taxpayer issued 30-year, 5% debentures with an aggregate principal amount of $10,589,900 in a tax-free reorganization for certain natural gas properties. The difference between the tax cost basis of the assets and the principal amount of the debentures was claimed as a bond discount. Both parties to the exchange were almost completely owned by a common third party.

[6] Taxpayer transferred 100, 10-year debentures, each with an issuance value of $1,000 and with a principal amount of $1,500. The notes were non-interest bearing and were redeemable prior to maturity at taxpayer's election in accordance with a schedule of payments. Taxpayer also assumed $60,752,740 of liabilities and received in exchange assets valued at $160,752,74.

available when the obligations are issued for property, thought it important that since the debentures could be redeemed at various times for various amounts, the cost of the property could not be determined until the redemption. This might not occur until long after the property had been resold. The court concluded that bond discount is the cost of using the money which is needed to purchase the property and found no support for the contention that the seller who also becomes a financing medium by accepting bonds should be treated differently than one who takes cash. *American Smelting* was cited with approval while it was recognized that the value of property is more uncertain than the value of cash.

The Court of Claims followed its *Montana Power* decision with very little discussion in *Southern Natural Gas Co. v. United States, supra*.[1] The holding that there can be no tax consequences as long as the property received for the securities is retained was again reiterated. The only factual difference in the cases was that *Montana Power* had involved a tax-free reorganization whereas the transaction in *Southern* was a taxable one. The court held that "the *Montana Power* rule was clearly meant to apply to the issuance of bonds for property in either situation." 412 F. 2d at 1238. Also, quoting the exact language of *Montana Power*, the court expressly refused to follow *American Smelting* to the extent that the cases were inconsistent.

[Determination of Discount]

Another factor of value determination, the amount originally received for the preferred stock by the taxpayer, was interjected into bond discount determination by the Court of Claims in *Erie Lackawanna Ry. Co. v. United States, supra*. On facts similar to the present ones,[2] the court stated:

"The position which this court . . . take[s] . . . is that since plaintiff was exchanging $100 debentures for preferred stock for which it had already received $100 in value, then plaintiff lost nothing as a result of the transaction. Since there was no actual difference between the face value of the debentures and the amount received in return for them ($100 preferred stock) there was no discount which could be amortized over the life of the bonds. The fact that the preferred stock had a market value less than the $100 at the time of the exchange is of no consequence in this type of transaction where the plaintiff is purchasing its own stock. What is important in this case is the value received for the stock at the time of its issuance." 422 F. 2d at 429.

However, it is important to note that the court did not rely on the principal or par value of the preferred stock in determining the value received by the corporation. Instead, it made an express finding that $100 was in fact the amount received at the issuance by the cancellation of $100 worth of debt. The court reserved the question of whether a bond discount would be allowable if the amount originally paid for the preferred stock had been less than $100. In discussing previous decisions, the Court of Claims distinguished the facts of *American Smelting*. It was a "crucial" difference that the exchange there had not involved the corporation's own stock but that of a subsidiary. The reasoning of *American Smelting* was also thought by the court to have been expressly overruled by its previous decisions in *Montana Power* and *Southern Natural Gas*. Similarly, *Industrial Dev. Corp.* and *Southern Fertilizer* were felt to be incorrectly decided and were rejected as authority.

In *Cities Service v. United States, supra*,[3] *Smelting* and *Nason Lens*, it was "well

[1] Pursuant to a taxable reorganization instituted under the Bankruptcy Act, taxpayer issued stock and 25-year 6% bonds with a par value of $100. In return, taxpayer assumed outstanding first mortgage bonds and received the predecessor's debentures and preferred stock. The fair market value of the assets received was claimed to be $71.50 for each exchange. The Commissioner allowed the amortization for the difference between par value and fair market value. Plaintiff then elected to redeem the bonds at face value before the expiration date and the discount not yet amortized was claimed as a deduction for that year. This was disallowed by the Commissioner.

[2] The holders of taxpayer's 5%, $100 par value preferred stock pursuant to an exchange offer approved by the ICC exchanged 277,762 shares thereof for a like number of 5% debenture in the principal amount of $100. The preferred stock was shown on taxpayer's books at full par value and was callable at par plus accrued and unpaid dividends. It was cancelled upon receipt. The total market value of the preferred stock at the time of the exchange was less than the maturity value of the debentures for which the shares of stock were exchanged, and this difference was claimed by taxpayer as bond discount.

[3] Taxpayer issued its thirty-year, 3½ debentures in the aggregate amount of $115,236,950. In return, it received all its outstanding no par preferred preference B and preference BB shares, all rights appertaining thereto and all dividend arrearages thereon. It was stipulated that the three classes of preferred and preference shares were issued by the plaintiff at various times in consideration for cash and properties, having an aggregate fair market value at the time of issuance of no more than $45,327,816.00. Further, it was agreed that at the time of the exchange the aggregate fair

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settled" in the Second Circuit that bond discount could occur in a bonds-for-property transaction. In blending the reasoning of both lines of cases, the court recognized that the conflict was more apparent than real. The difference between the face amount of the bonds issued for property and the market value of the property acquired was bond discount because it represents the cost of the money that would otherwise need to be borrowed in order to make a cash payment for the property received. Further, the court recognized that something other than a "mere reshuffling of assets" had occurred:

> "The effect of the exchange was a radical change in plaintiff's debt obligation. In lieu of a conditional obligation to pay dividends on the preferred and preference shares, depending upon earnings and the management's good faith exercise of its discretionary powers, plaintiff now becomes firmly and unconditionally obligated to pay the face amount of the new debentures plus 3% interest annually on the unpaid balance. . . . The 'expedient' in question, if it can be so called, involved far more than the substitution of currencies urged by the defendant. It involved the assumption of enlarged and unconditonal obligations by the plaintiff, as a result of which deductible losses have been realized." 316 F. Supp. at 72.

However, the original consideration of the shares received in the exchange was also recognized as a determinative factor. The court ruled that the minimum amount which could be ascribed to the shares acquired was the original consideration which had been received upon issuance. Having received the cost price upon issuance, the taxpayer could not sustain a loss to a greater extent. The original consideration was only the lowest figure at which the value could be established. The actual value could be determined only after a review of such factors as market value of the shares, the financial condition of the taxpayer at the time of the exchange, the prospects of profits and expert opinion. As a result, the motion for summary judgment was denied and a trial was directed to determine the value of the shares received.

[Discount in Stock-Bond Case]

Relying heavily on *Cities Service*, the Court of Claims in *Missouri Pacific Ry. Co. v. United States, supra*,[9] refused to adopt the position that no discount can arise on an exchange of bonds for the old securities of a corporation. It indicated that while the amount received for the old securities which are retired might be the minimal consideration or floor to be ascribed to the securities for purposes of calculating discount, it cannot be the ceiling. No trial was necessary to determine value since it had already been determined in the reorganization proceedings. The Court purported to follow its decision in *Erie Lackawanna*. However, market value was not considered "of no consequence" as in *Erie*, but instead was a "factor" which, although not conclusive, was still to be weighed in the analyses. Also, even though *Erie* had found *American Smelting* of no value as authortiy because of the "crucial" difference that the stock received there had been that of a subsidiary, the Court of Claims in *Missouri Pacific* announced a rule that applied to exchanges involving "shares of its own stock or stock of its subsidiaries." 433 F. 2d at 1325.

The Tenth Circuit had occasion to consider bond discount in a bonds-for-property situation in *Atchison, Topeka and Santa Fe Ry. Co. v. United States, supra*.[10] The fact that the Regulation concerning bond discount does not distinguish between bonds issued for cash and bonds issued for property was held to be a *sub silentio* recognition that discount could exist in both cases. Recognition of such a situation was thought to most conform the law with economic and

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market value of the preferred and preference shares was $86,313,600.00. Plaintiffs repurchased the debentures at face amount and claimed bond discount for the difference between that amount and either the original purchase price or the fair market value at the time of exchange.

[9] Taxpayer was reorganized pursuant to a plan approved by the ICC and its trustee under Sec. 77 of the Federal Bankruptcy Act. Collateral trust notes, first mortgage 4½% bonds, general mortgage 4½% income bonds, 5% series of debentures and stock was issued for its outstanding debt securities and stock of its subsidiaries. The difference in the aggregate maturity value of the new bonds and the fair market value of the old securities given in exchange was claimed by the taxpayer to be amortizable over the life of the bonds as original issue discount.

[10] Taxpayer was formed as the successor company to receive the assets of the old company pursuant to a court ordered sale of the assets during the course of a bankruptcy reorganization. The trial judge ruled that taxpayer issued bonds and securities in exchange for the bonds and securities of the old company. The issue on appeal was not the nature of the transaction—bonds for bonds or bonds for property—but only discount can arise in any bonds-for-property transaction.

business reality. The heavy burden of proof was satisfied by "substantial evidence from experts in railroad securities and properties who relied on the documents surrounding the reorganization, market conditions and actual trading, and valuation of the railroad properties." 433 F. 2d at 153. Since a bonds-for-property exchange was at issue, the court saw a conflict in the Third Circuit opinions of *American Smelting* and *Montana Power*. The earlier view of *American Smelting* was regarded as the more persuasive.

The most recent Court of Claims pronouncement in the bonds-for-stock area is *St Louis-San Francisco Ry Co. v. United States, supra.*" There, *Erie Lackawanna* and *Missouri Pacific* were regarded as binding authority. Original consideration value was not an issue, however, since the taxpayer did not contend that the maturity value of the debentures exceeded the amount it received when it issued the preferred stock. In discussing *Erie Lackawanna*, the court concluded that that case had "rejected the use of fair market value as a *determinative* measurement of debt discount when bonds were exchanged for preferred stock." (emphasis added) 28 A. F. T. R. 2d at 5345. The key element in that case was the value to the corporation of the stock received in the exchange. *Missouri Pacific* was also held to have rejected market value alone as determinative of the value of stock in favor of a consideration of all relevant information, including the market value, the financial conditions of the taxpayer, profit prospects and expert opinion. No trial was necessary, however, since a valuation of the shares had already been made.

[*Discount Based on Value Received*]

Besides *Southern Fertilizer*, the other decision by a District Court in the Fifth Circuit which has addressed the issue is *Claussen's Inc v. United States, supra.*" No claim was made in that case, nor proof offered, concerning market value. Instead, the taxpayer deducted the difference between the face value of the debentures and the value received for the exchanged upon issuance as amortizable bond discount. The court allowed the full discount, saying that the fact that the exchange is for the stock of the issuer rather than for cash is of no importance. *Missouri Pacific, Cities Service* and *Erie Lackawanna* were cited in holding that the measure of the bond discount is the difference between the par value of the bonds issued and the value of the stock to the taxpayer at the time of the exchange.

The Tax Court entered the fray concerning bonds-for-stock exchanges in the recent opinion of *National Alfalfa Dehydrating and Milling Co. v. Commissioner, supra.*" Citing *Erie Lackawanna* and *Missouri Pacific*, the decision appears to limit inquiry concerning value of the amount received by the taxpayer when the original stocks or bonds were issued. Further, the reasoning of the court harkened back to the "mere reshuffling of assets" viewpoint by characterizing the exchange from the corporations standpoint as "merely the exchange of one form of interest . . . for another." 40 L. W. at 2245. The Tenth Circuit opinion of *Atchison, Topeka and Santa Fe* was distinguished because in that case the only issue was whether bond discount could arise in a bond-for-property exchange and not whether the value of the stock was to be measured by the fair market value or by the consideration received at issuance.

The court, in reaching a decision in this matter, notes initially that it is not called upon to consider bond discount in a bonds-for-property transaction. The decisions dealing with this type of exchange, namely, *Montana Power Co. v. United States* [56-1 USTC ¶ 9402], 232 F. 2d 541 (3rd Cir. 1956), *Montana Power Co. v. United States* [58-1 USTC ¶ 9332], 159 F. Supp. 593 (Ct. Cl. 1958), *Nassau Lens v. Commissioner* [62-2 USTC ¶ 9723], 308 F. 2d 39 (2nd Cir. 1962), and *Atchison, Topeka and Santa Fe Ry Co. v. United States*, 71-1 USTC ¶ 9430 (10th Cir.

" In 1956, taxpayer exchanged its Series A, 5%, $100 par value income debentures, maturing on Jan. 1, 2006, plus cash and common stock for its outstanding Series A, 5%, $100 par value preferred stock. The transaction was considered a reorganization under Sec. 368(a)(1) of the Internal Revenue Code of 1954—a recapitalization under Sec. 368(a)(1)(E). Amortizable bond discount was claimed for the difference between the fair market value of the preferred stock and the maturity value of the debentures.

" Taxpayer issued two classes of common stock in 1954. In 1956 the shareholders approved a plan of recapitalization whereby each share of the outstanding common stock would be exchanged for ½ new share of common stock, a warrant to purchase ½ of a share of new common stock at $5.50 per share and a 6%, $10 debenture maturing in 40 years. The par value of the assets given to the old stockholders was $2,325,000. The value received for the A and B stock at issuance was $1,962,500. The difference of $362,500 was claimed as amortizable bond discount.

" In a 368(a)(1)(E) recapitalization, taxpayer exchanged bonds with a face value of $50 for preferred stock with a par value of $50 and cancelled the stock after the exchange. Taxpayer claimed the difference of face value and fair market value as amortizable bond discount.

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1971), therefore are inapposite to the present considerations.

[Stock Issuance Price]

This court is convinced that an exchange of a corporation's income debentures for its outstanding preferred stock is more than a "mere reshuffling of assets." Instead, a very basic transformation has occurred in the capital structure of the corporation. A creditor, with full rights, has been substituted for what had previously been one with owner interest in the company. An obligation to pay the face amount of the debentures plus the interest rate has been created from what once was a discretionary power depending only upon earnings and the good faith of management. Also, from the corporation's standpoint, a deductible yearly expense has been substituted for non-deductible dividend payments.

Since some transformation of the capital structure has occurred in both a bonds-for-cash exchange and a bonds-for-stock exchange, the court sees no reason why bond discount should occur in one and not the other. However, the court is not convinced that the market price should be the determinative measurement of bond discount. To the contrary, the arguments of *Cities Service Co. v. United States, supra*, are deemed the more persuasive. The issue price is the value assigned by the corporation to the stocks that it issues. Because of subsequent events in the marketplace which may tend to devalue the stocks, the corporation attempts through bond discount to assign a new value to the stocks. In so doing, the corporation is attempting to make use of losses which have been borne by its shareholders in the marketplace, thus, in essence, utilizing the loss a second time. This the court is unwilling to allow. In this line of thinking, the court joins with several previous decisions. *See, Erie Lackawanna Ry. Co. v. United States* [70-1 USTC ¶ 9245], 422 F. 2d 425 (Ct. Cl. 1970); *Missouri Pacific Ry. Co. v. United States* [70-2 USTC ¶ 9698], 433 F. 2d 1324 (Ct. Cl. 1970); *Claussen's Inc. v. United States*, 71-2 USTC ¶ 9632 (S. D. Ga. July 29, 1971); *Cities Service v. United States* [70-2 USTC ¶ 9537], 316 F. Supp. 61 (S. D. N. Y. 1970); *National Alfalfa Dehydrating and Milling Co. v. Commissioner* [CCH Dec. 31,030], 57 T. C. No. 6, 40 L. W. 2247 (Tax Ct. Oct. 14, 1971).

The decisions of *Erie Lackawanna*, as explained by *Missouri Pacific and St. Louis-San Francisco Ry. Co.*, and of *Cities Service* are further followed to the extent that proof of market value is considered important in establishing that the value of the stock to the corporation might be greater than the issue price. Since the only value in the facts now before the court is the stated price of the stock, a hearing is necessary to make a determination as to the correct fair market value of the stock at the time of the exchange. According to *Cities Service*, the original issue price of the stock must be ascertained as well.

Several of the previously discussed cases are distinguishable from the present one and thus not in conflict with it. There was no original issue price in *American Smelting* because the exchanging corporation received the shares of a wholly-owned subsidiary. Therefore, the market value was the only one with which the court could measure bond discount. Similarly, *Southern Fertilizer* and *St. Louis-San Francisco Ry. Co.* did not consider the issue price. In the former case, the value of the stock was stipulated and in the latter, the taxpayer did not contend that the maturity value of the debentures exceeded the amount it received when it issued the preferred shares. The rationale of *Southern Natural Gas* also is of no consequence because here the stock received in the exchange was retired. The pivotal point in *Southern Natural Gas* was that the stock was retained and so could not be valued.

Therefore, pursuant to Rule 56(d), F. R. Civ. Proced., it is hereby ORDERED, ADJUDGED, and DECREED that no genuine issues exist as to the plaintiff's claim except as indicated. The measurement of bond discount shall be the difference between the issue price originally received by taxpayer for the preferred stock and the par value of the bonds, except if it can be shown that the fair market value of the preferred stock at the time of the exchange was greater than the issue price. Then, the bond discount shall be the difference between the fair market value of the preferred stock and the par value of the bonds. Provided however, that no bond discount shall exist if either the issue price or the fair market value of the preferred stock exceeds the par value of the bonds. Evidence as to the issue price of the preferred stock and the fair market value of the preferred stock shall be received by this court after which time a determination as to bond discount shall be made.

APPENDIX G

railroad corp. for bonds issued by it upon receipt of its preferred stock pursuant to reorganization plan in which taxpayer was surviving company. Since fair market value per share of preferred stock was greater than bond issue price, there was bond discount. Bond discount measured as difference between fair market value of preferred stock at time of exchange and par value of bonds. *Reference:* 1973 P-H Fed. ¶7350. '54 Code Sec. 61.

2. LOSSES—Specific types of property—other property or enterprises. Loss deduction denied railroad corp. for railroad grading. Uses and potential uses of grading negated claim of abandonment. *References:* 1973 P-H Fed. ¶ 14,251; 15,433. '54 Code Secs. 165, 167.

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* * *

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Judgment And Decree

These consolidated actions for the refund of income taxes plus assessed and statutory interest paid by the Gulf, Mobile and Ohio Railroad (hereinafter "taxpayer") were heard by this court sitting without a jury.

These civil actions are brought under Section 1346(a)(1) of Title 28 of the United States Code for the recovery of Federal income tax and interest assessed on such tax (plus interest on any recoveries allowed herein as provided by law) paid by the taxpayer for the calendar years 1959 and 1961.[1]

The taxpayer is a corporation duly organized and existing under the laws of the State of Mississippi and maintains its principal office and place of business in Mobile, Alabama.

It was, during all pertinent and relevant periods, engaged in the railroad business as a common carrier in the transportation of persons and property in interstate commerce and is subject to the jurisdiction of the Interstate Commerce Commission (hereinafter referred to as ICC).

The issues heard by the court and which are now to be decided are:

(1) whether taxpayer is entitled to deductions in 1959, 1961, and 1964 for bond discount allegedly arising from the exchange to

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GULF, MOBILE AND OHIO RAILROAD COMPANY, PLAINTIFF v. U.S., DEFENDANT. U.S. District Court, S. Dist. of Ala., S. Div. Civil Action Nos. 5662-69-P, 6332-70-P. Nov. 27, 1972. Year 1972. Decision for taxpayer in part and for Govt. in part.

1. INCOME—Corporation's transaction in own bonds—discount on bonds issued for property. Bond discount deduction allowed

[1] The years 1959 and 1961 are the only ones at issue since the deductions claimed with respect to the year 1964 gave rise to a net operating loss for that year which plaintiff has carried back and claimed as a deduction for the year 1961.

its shareholders of its 5% income debenture having a maturity value of $100 each for a like number of its no-par preferred stock, $5.00 Series, with a stated value of $100 per share; and

(2) whether taxpayer is entitled to deductions on its returns for certain railroad grading located in the State of Illinois which it allegedly retired and abandoned in the years 1961 and 1964.

I. Bond Discount Issue

Upon defendant's Motion for Partial Summary Judgment and plaintiff's Cross Motion for Partial Summary Judgment, this court ruled that as a matter of law bond discount can arise when a corporation issues its income debentures in exchange for its already outstanding preferred stock. G.M.&O. v. U.S., 339 F.Supp. 489 [29 AFTR 2d 72-1075] (S.D. Ala. 1972). The determination of whether the bonds were issued at a discount was held to be a factual one which must be made on a case by case basis. The standards for such a determination were established by this court as follows:

> "The measurement of bond discount shall be the difference between the issue price originally received by taxpayer for the preferred stock and the par value of the bonds, except if it can be shown that the fair market value of the preferred stock at the time of the exchange was greater than the issue price. Then the bond discount shall be the difference between the fair market value of the preferred stock and the par value of the bonds. Provided however, that no bond discount shall exist if either the issue price or the fair market value of the preferred stock exceeds the par value of the bonds."

The issue before the court thus becomes whether the taxpayer has sustained his burden of proof in this instance as to the issue price originally received for the preferred stock and its fair market value at the time of the exchange. Before a discussion is undertaken as to this issue, however, a recitation of the relevant circumstances involved in the various transactions should be helpful.

The preferred stock in question was originally issued pursuant to a plan of reorganization formulated under the supervision of this court. Prior thereto, on June 3, 1932, this court had appointed receivers for the purpose of operating the properties of the Mobile and Ohio Railroad Company (hereinafter referred to as M&O). The plan of reorganization, which was approved by the ICC on October 13, 1939, contemplated the unified operation of the properties of the M&O and the properties of the Gulf, Mobile & Northern Railroad Company (hereinafter referred to as the GM&N) and the New Orleans Great Northern Railway Company (hereinafter referred to as NOGN). In the formulation of the plan, a new corporation, the taxpayer herein, had been formed on November 10, 1938, for the purpose of acquiring and operating these properties.

On June 14, 1940, this court entered a Final Judgment and Decree of Foreclosure and Sale of the properties of the M&O over which it had supervision pursuant to the equity receivership proceedings. Pursuant to that judgment, on August 1, 1940, the properties of the M&O were purchased at foreclosure sale by the M&O bondholders reorganization committees, free and clear of the various liens of its funded debts, except equipment obligations, which were to be assumed by the new corporation, the taxpayer. The total purchase price for the properties was $13,411,000. The sale was subsequently confirmed by this court in equity on August 22, 1940. On September 4, 1940, the bondholders' reorganization committee conveyed these properties to taxpayer in exchange for its issuance of the following securities:

(a) For each M&O $1,000 Refunding and Improvement Gold 4½'s, Series of 1977, due September 1, 1977, GM&O issued:
(1) $300 face value First and Refunding Mortgage 4's, Series B due July 1, 1975;
(2) $200 face value General Mortgage Income 5's, Series A due July 1, 2015;
(3) 6.25 shares of preferred stock;
(4) 12.5 shares of common stock; and
(5) Cash.

(b) For each M&O $1,000 5% Gold Note due September 1, 1938, GM&O issued:
(1) $350 face value First and Refunding Mortgage 4's, Series B due July 1, 1975;
(2) $250 face value General Mortgage Income 5's, Series A due July 1, 2015;
(3) 7.75 shares preferred stock;
(4) 15.5 shares of common stock; and
(5) Cash.

(c) For each M&O $1,000 Montgomery Division First Mortgage 5% due 1947, GM&O issued:
(1) $500 face value General Mortgage Income 5's, Series A, due July 1, 2015;
(2) 6.5 shares of preferred stock; and

(... 13 shares of common stock.

Shortly ...ter taxpayer's purchase of the assets of th... M&O, it was consolidated with the GM&N ...rsuant to the plan of reorganization. The ...xpayer was the surviving company. The ...llowing exchange was effected by the con...nies:

For each ...hare of GM&N $100 par value, 6% pref...ed stock, including accumulated divi...ds which amounted to 72%, GM&O ...ued:
(1) 1 sh... of preferred stock; and
(2) 1.5 ...es of common stock.

The pla... reorganization also provided that the ...xpayer was to acquire the GM&N's l... said interest in the NOGN by issuing its ...rities for those of the NOGN. The exchan... provided:

For eac... $1,000 5% Income Debenture of the NO... the GM&O issued:
(1) 10 ... of preferred stock; and
(2) 71.... es of common stock.

The de... of the exchange in the years 1957-1962 ...t out in this court's earlier ruling, G.M... v. U.S., 339 F.Supp. 489 [29 AFTR 2d ...1075] (S.D. Ala. 1972). It is sufficient ... purposes here to state that the taxpayer ... its 5% income debentures having a m... ity value of $100 upon receipt of its pref... stock which had been issued in the abo... mailed transactions.

The co... ruling of February 18, 1972, setting out ... the taxpayer prove both the exchange v... and the original issue price of the preferr... ...ck, was an acceptance of the reasoning ... District Court in Cities Service Comp... United States, 316 F.Supp. 61 [26 AF... 70-5378] (S.D.N.Y. 1970). In that ca... the fair market value of the stock exch... for the debentures was established ... as to the aggregate closing market pri... the shares on the day before the exchan... adjusted by an expert appraisal of ... ares to eliminate the effects of the im... exchange. The original issue price ... shares, however, was to be determined ... a separate hearing after consideration ... "market value of the shares, ...ndition of the taxpayer at the time of th... change, its profits prospects and experi...ion." Id., at 73.

The ev... presented in the hearing of this case o... fair market value of the preferred stoc... the 1957-1962 period consisted of the ... ted market price (Joint Exhibit 1), e... opinion testimony and exhibits. The ...ated market price of $55% per share ... preferred stock surrendered was an ave... of high and low prices on the New York ... Exchange on the date that exchanges ...ted, or if no sales took place on that date, on the last preceding date on which sales were reported. This expert opinion was based upon market analysis of comparable railroad securities (Plaintiff's Exhibit B) and took into account the future prospects of the railroad, the priority of the preferred stock, the earnings of the preferred during the period and the attitude of the investors toward railroad securities.

Part of the controversy in this action centers around the proof of the issue price originally received by the taxpayer for the preferred shares. It is the defendant's position that the preferred shares were originally issued for the assets and not the stock, bonds, or other securities of the M&O. In either case, whether stock, etc., or assets were received, the defendant maintains that taxpayer has not met its burden of proof in this instance and should be allowed no bond discount.

[1] Defendant's contention concerning the true nature of the exchange between the GM&O and the M&O was before the Tenth Circuit Court of Appeals in Atchison, Topeka and Santa Fe Railroad Company v. U.S., 443 F.2d 147 [27 AFTR 2d 71-1587] (10th Cir. 1971). On facts resembling those now at bar, that Court ruled "especially in reorganization cases the end result of the series of interrelated steps controls the tax consequences of the whole." Id., at 151. Accord, Davant v. C.I.R., 366 F.2d 874 [18 AFTR 2d 5523] (5th Cir. 1966), cert. den. 87 S. Ct. 1370, 386 U.S. 1022, 18 L.Ed.2d 460, rehearing den. 88 S. Ct. 14, 389 U.S. 893, 19 L.Ed.2d 203; Liddon v. C.I.R., 230 F.2d 304 [49 AFTR 231] (6th Cir. 1956), cert. den. 77 S. Ct. 34, 352 U.S. 824, 1 L.Ed.2d 48; Budd International Corp. v. C.I.R., 143 F.2d 784 [32 AFTR 1071] (3rd Cir. 1944), cert. den. 65 S. Ct. 562, 323 U.S. 802, 89 L.Ed. 640.

Although it was recognized that the mechanics of an insolvency reorganization ordinarily involves a purchase of the old company's assets by the new company, the essential agreement between the new company by the reorganization's committee, who were the purchasers, and the security holders had to do with what the security holders should receive, to wit, the stock, from the new company for giving up their intangible claims against the old company. New York, C. & St. L. R. Co. v. Burnet, 64 F.2d 152 [12 AFTR 2d 383] (C.A.D.C. 1933) was distinguished in that it was decided before the step-transaction doctrine became established.

A close review of the Plan of Reorganization (Joint Exhibit 2) reveals that the reasoning of the Santa Fe case is especially applicable here. In that agreement, the reorganization committee was given all necessary powers (pg. 18) and assumes the

liability (pg. 25) to carry out the purposes of the agreement. Those purposes, as stated on page 4, are:

> "(a) Reorganization of M&O whereby a newly organized corporation to be known as Gulf, Mobile and Ohio Railroad Company (below referred to as the "New Company") will acquire all or substantially all of the properties of M&O presently held by its Receivers.
>
> . . .
>
> (b) Unified operation by the New Company of such M&O properties and the properties of GM&N and NOGN."

Thus, it is apparent that from the very inception of the plan, any purchase by the reorganization committee was intended to be only a tentative arrangement until the final transfer to the GM&O could be accomplished, and it would not be contrary to sound reasoning to hold the preferred shares were originally issued in exchange for the securities of the M&O, the GM&N, and the NOGN.

The taxpayer offered evidence that the fair market value of the preferred stock was $70.00 per share at the time of the 1957-1962 exchange. (The court hereinafter in this decree finds that the fair market value of preferred stock during 1957-1962 was $80.00 per share.) It then introduced evidence showing that the price originally received for the preferred was less than that figure. Charts were introduced which, using the monthly N.Y.S.E. quotations from January, 1930 through September, 1940, established the market value of the securities received for the GM&O preferred stock as follows (Plaintiff's Exhibit D):

(a) M&O Securities	
5% secured notes	$421.25
Ref. & Imp. Mtg. Bonds	352.50
1st Mtg. 5%, Montgomery Div.	261.25
(b) NOGN Securities	
4% Income Debentures	100.00
(c) GM&N Securities	
6% preferred stock, $100 par	11.00

Based upon these market quotations, even if the GM&O preferred stock were the only things given in return for each of these securities, which, of course, they were not, the issue price was much less than $80.00 per share.[1]

The taxpayer's expert testified that in his opinion the allocable fair market value of the securities received by the GM&O upon the issuance of its preferred stock was approximately $9.50 to $11.00 per share, which the court accepts. His testimony was based upon the market quotations of the securities of the constituent corporations prior to the consummation of the reorganization (Plaintiff's Exhibit D), the market quotations of the securities of the GM&O after issuance (Plaintiff's Exhibit D), the earnings record of the constituent corporations prior to the consummation of the reorganization in 1940 (Joint Exhibit 11), and the price earnings ratio of other railroads as compared with those of the constituent corporations (Plaintiff's Exhibit E). This evidence attempts to comport with the guidelines of Cities Service, supra, at 73, that the relevant considerations should be the "market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects and expert opinion."

Even if held that the GM&O preferred stock was exchanged for the assets of the M&O, there seems to be ample evidence for a finding that the issue price was much less than the fair market value of $80.00 per share. The upset price set by this court before the judicial sale (Joint Exhibit 7), the bid price at the sale (Joint Exhibit 7), and the Internal Revenue Service Ruling of 1942 (Joint Exhibit 10) establishing the base of the properties, all give values less than that figure. In fact, the only evidence which tended to establish a higher valuation for the property was a determination by the ICC that the issue price for the preferred stock was $100.00 per share. This determination was based upon the book value of the assets being purchased by the GM&O. While an evaluation of assets at the time of the exchange might be persuasive to the court, a valuation based upon the generally unrealistic book value is deemed to be of little or no probative value and is not persuasive here.

Defendant would have the court rule that there has been a failure by the taxpayer to

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[1] 25 shares of GM&O preferred in exchange for each M&O Ref. & Imp. Mtg. Bonds at $352.50 per bond results in an issue price of $56.40 per share.

7.75 shares of GM&O preferred in exchange for each M&O 5% secured at $421.25 per share results in an issue price of $54.35 per share.

6.5 shares of GM&O preferred in exchange for each M&O 1st Mtg. 5%, Montgomery Division, at $261.25 per share results in an issue price of $40.18 per share.

10 shares of GM&O preferred in exchange for each NOGN Income Debenture at $100 per share results in an issue price of $10 per share.

1 share of GM&N preferred in exchange for each GM&N preferred at $11.00 per share results in an issue price of $11.00 per share.

prove the consideration originally received by the GM&N upon issuance of its preferred stock subsequently exchanged for taxpayer's preferred in the 1940 reorganization. Such a ruling would require a taxpayer to trace each stock back to its original cash or property exchange. This burden is practically impossible in view of the history of relatively frequent railroad reorganizations and stock transfers.

Finally, defendant contends that taxpayer has not met its burden of proof because it did not establish the precise number and origin of the preferred shares received by it in exchange for the debentures. Specifically, no evidence was offered concerning the 705 shares of preferred stock issued after the offer of reorganization and before the exchange offer in 1957. Also, it was established that taxpayer's expert, in his analysis, did not attempt to determine whether 986⅔ shares of preferred stock which were reacquired and cancelled before the 1957 exchange offer were originally issued for the securities of the M&O, the GM&N, or the NOGN.

A method of proof by which each individual share of stock is accounted for and individually traced through the myriad of reorganizations and exchanges would undoubtedly be the most desirable and helpful to the court. However, in the context of this case, with a total of 283,483⅓ shares of stock outstanding, and the wide disparity between the established fair market value of the preferred stock in 1957-1962 and the issue price in 1940, the failure to determine precisely the effect of these stocks is not deemed to be significant.

The court, as the trier of facts, which includes an evaluation of the witnesses and their evidence, finds the fair market value of the preferred stock per share to have been $80.00.

The plaintiff's expert has been a paid consultant of the plaintiff for many years. After careful questioning by the court under certain hypothesized facts, it is the court's judgment that there is an understandable conservative bias in favor of the plaintiff which tips the balances of his judgment to a posture unduly favorable to the plaintiff. The court's rule as to the means of determining the measurement of bond discount in its order on motion for partial summary judgment should be qualified in its application to the particular facts of this case. When a company, as the plaintiff here, is seeking to obtain all of it outstanding preferred stock by an exchange and where it is likely that as much as two-thirds of that stock will be obtained, as occurred in this case, a situation is brought into being different from the usual buying and selling in relative small blocks as takes place day to day on the stock exchange. It is rather obvious that the company stood in a position of preferred expertise and knowledge which was not shared by the average stockholder.

The Government's expert, assuming a tax bracket of 52% for the plaintiff and taxable earnings every year for the life of the bonds, calculated that the stock was worth to the plaintiff up to $121.58 and not less than $100 per share. It is a calculation based on optimum conditions. The $121.58, of course, does not anticipate a loss for any year. We know this is contrary to what has happened since the exchange took place. On the other hand, the taxpayer's expert testified the effect of the huge tax benefits possible to the taxpayer as being miniscule in projecting the market value of the stock at $70.00 per share, completely discounting the taxpayer's obvious advantage in paying upwards of $100.00 per share if necessary to obtain the stock.

Apparently, the taxpayer did not anticipate a bond discount savings at the time of the exchange nor until two or three years had elapsed thereafter. It is clear the stockholders were not informed and did not anticipate a possible tax liability to them in the event of a bond discount.

An additional factor stressed by the Government must enter into a figure of fair market value in this case. Any bond discount granted to the taxpayer could result in ordinary income and therefore additional tax liability of the shareholders who participated in the exchange. This created an upward thrust to the fair market value of the stock most difficult to assess. The equities between the taxpayer and the stockholders must not be overlooked.

A similar equitable situation arose and was the basis of the Court of Claims decree in Bethlehem Steel v. U.S., 26 AFTR 2d 70-5021 [70-5028] denying an interest deduction. In view of the lack of evidence that a significant saturnine would have resulted had these facts pertaining to a bond discount been known, this consideration should not compel an outright denial of a bond discount in this case.

In projecting the market value of the stock at the time of the exchange by adjusting the rule of measurement set out by this court in its summary judgment order to the evidence as above evaluated, the court finds that if there is to be a willing buyer in full knowledge of all factors affecting the market price and a willing seller with the same information and neither acting under compulsion and operating on a free market, " the value of the stock would necessarily have been higher

" [P]rice at which the stock would change hands between a willing buyer and a willing seller, neither of whom is under any compulsion to buy or sell and both of whom are reasonably well informed as to the facts having a bearing on value." Bader v. U.S., 172 F. Supp. 831, 836 [3 AFTR 2d 1824] D.C.

than that estimated by the plaintiff's expert. In further consideration of the equities between the taxpayer and the stockholders, the Court has adjusted that figure upwards to $80.00.

Therefore, it is this court's determination that the taxpayer has met the burden of proof established in its February 18, 1972 order. Furthermore, since the $80.00 fair market value per share of preferred stock at the time of this exchange was greater than the issue price of approximately $11.00 per share, the measurement of bond discount here is the difference between the fair market value of the preferred stock at the time of the exchange and the par value of the bonds.

A bond discount was realized by taxpayer upon the issuance of its 5% income debentures having a maturity value of $100.00 in exchange for a like number of its no-par preferred stock, $5 Series, with a stated value of $100 per share. The bond discount shall be calculated as the difference between the fair market value of the preferred, or $14,-999,280, and the par value of the bonds which were issued in exchange thereof, $18,-711,600, or a total discount on the exchange of $3,742,320.

II. Abandonment of Grading Issue

During the period 1959-1964, plaintiff installed a centralized traffic system on various segments of its mainline track located in the State of Illinois. Prior to installing this system, the plaintiff used two separate tracks, northbound and southbound, over which its trains passed. As a result of installing the new system, plaintiff needed only one line of track so rails, ties, and some ballast of one line of track were taken off during the years 1961-1964, leaving only one line of track where there had been two.

Plaintiff contends that when the second line of track was removed, the underlying grading associated with such track was permanently retired or abandoned and since such grading is property used in a trade or business, it should be allowed a reduction under Section 167 of the Code or an abandonment loss deduction under Section 165 of the Code. There is approximately 42 miles of roadbed involved. All 42 miles of the claimed abandoned roadbed runs parallel to the single remaining track. The cross section of both tracks is one unit and constitutes one bed save and except one portion of 3.3 miles near Springfield where the single bed and double tracks divide into separate beds and single tracks. The defendant has permitted a deduction for this limited area where the tracks separated and did not comprise a single unit.

The single roadbed carrying two tracks from which one was removed, and the proximity of the vacated portion of the bed to the remaining mainline track, if not precluding a concept of abandonment, militates to such an extent against a concept of abandonment that the court is not persuaded by a preponderance of the evidence that there has been an abandonment.

The minimum industrywide cross-section of a roadbed for a single track is 21½ feet for fills and 40 feet for cuts. The roadbed for the dual track on an average was 30 to 32 feet for fills and 52 feet for cuts. On all of the areas claimed by the plaintiffs, it is contended that they have abandoned the adjacent roadbed and are now only using 21½ feet of the fills and 40 feet of the cuts and the excess should be considered as abandoned.

There is some movement, although not prevalent industrywide, toward the recognition of wider roadbeds, to wit, 26 feet for new construction.[3]

It is undisputed that the claimed abandoned roadbed would deteriorate very little, if any, for many years, and, in effect, has an indefinite life. The claimed abandoned area aids and facilitates drainage. The wider cuts minimize rock, earth and other vegetation from falling on the remaining track. Although there does not appear to be daily, weekly, or even monthly, use of many areas of the claimed abandoned track for off-track maintenance, there is clear evidence of vehicular use for maintenance in certain areas by reason of field road type vehicle tracks on the claimed abandoned roadbed at several intervals.

Several witnesses, of which one was plaintiff's expert, from spot checks on four separate occasions, testified some use was being made of the claimed abandoned track in connection with the existing track. The very

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[P]rice which willing buyer would pay to willing seller, neither being under compulsion to buy or sell, and both having full knowledge of all pertinent facts." In re Powell's Estate, 282 P 2d 163, 168 (Cal. App. 1955)

[3] Defendant's expert, Caywood, a Chief Engineer of Audubon, Ohio, joined in such a recommendation in 1964, plus a 12 foot access road when practical. The New York Central in the 1960's, in the reconstruction of a new single roadbed, constructed it wider than the dual track roadbed in the instant case to provide for the movement of off-track motor vehicles, maintenance and repair equipment, and to minimize the danger of rock falls, etc. in cuts.

presence of the firm roadbed immediately adjacent to the existing track invites use over the years. It will undoubtedly be used in the event of derailments, for open storage of crossties and other maintenance equipment.

The use of a single track to carry trains which formerly operated on two tracks has substantially increased the need for maintenance on the single track. The wider roadbed sought to be abandoned provides a safe area for maintenance workers and material and equipment without the necessity of trains using the track reducing their speed.

Although signal towers at intervals of approximately one mile have been moved onto portions of the former track area, the entire remaining track runs through relatively flat or slightly rolling type terrain. Vehicles can easily pull around the signal towers.

The evidence is uncontradicted that there is an existing public highway which runs parallel and within a relative few feet of most of the track with numerous crossings to the opposite side. These crossings afford ready access for off-track motor vehicles for maintenance work. This greatly minimizes the interrupting effect of the signal towers at mile intervals.

The plaintiff has recognized and expressed an intention to use the double track area in communications to the Highway Planning Authorities in the State of Illinois in connection with the construction of bridges. It has repeatedly insisted that the piers of the overhead roads constructed by the State give full clearance to the double track area and cited specifically the future possible use of the roadbed for the construction of highspeed trains in connection with nationwide "Railpacks."

[2] The court concludes that the uses and potential uses negate the claim of abandonment, and, to the contrary, clearly show the taxpayer continues, and will continue, to derive considerable benefit from the alleged abandoned roadbed.

This court agrees that:

"Not until there has been a complete and permanent retirement or abandonment of the grading would the taxpayer be allowed a deduction under either §167 or §165. A mere lessening or decline in the value of an asset to a taxpayer by reason of excess capacity does not create a deductible loss." Western Maryland Railway Co. v. U.S. 291 F.Supp. 935, 940 [23 AFTR 2d 69-547] (D. Md. 1968), Maryland C. Ct., p. 940, citing Reporter Publishing Co. v. Commissioner, 201 F.2d 743, 744 [43 AFTR 224] (10th Cir. 1953), cert. den. 345 U.S. 993, 73 S. Ct. 1133, 97 L. Ed. 1401 (1953); New York Sun, Inc. v. Commissioner, 27 T.C. 319, affirmed per curiam, 253 F.2d 487 [1 AFTR 2d 1205] (2d Cir. 1958).

All that has been shown by the facts is a decrease, albeit substantial, in the use of the claimed abandoned property. The grading and improvement of the roadbed are in place available for use by the railroad. It is being used by the railroad, and unquestionably will be used in the future to a varying extent depending on many factors which indicates a use of more than incidental value to the plaintiff.

It is therefore Ordered, Adjudged and Decreed that the taxpayer is entitled to, and a judgment is hereby rendered for the plaintiff and against the United States of America for, recovery of Federal income tax and deficiency interest thereon, for the taxable year ending December 31, 1959 and December 31, 1961, arising from a bond discount as hereinbefore set out in this decree.

It is further Ordered, Adjudged and Decreed that the taxpayer is not entitled to deductions on its returns for the years claimed for certain railroad grading located in the State of Illinois which it claimed was retired and abandoned, therefore, it is Ordered, Adjudged and Decreed that judgment be, and is hereby, entered for the defendant on this issue.

Costs are taxed against the defendant.

¶ 73-349

Dr. Hollis K. (III) and Patricia D. LEATHERS, APPELLEES v. U.S., APPELLANT. Dr. William F. and June B. Blankenship, Appellees v. U.S., Appellant. U.S. Court of Appeals, Eighth Circuit. Nos. 71-1647, 71-1648. Dec. 20, 1972. District Court, 28 AFTR 2d 71-5458, affirmed. Years 1968-1969. Decision for taxpayer. 471 F. 2d 856.

1. INCOME EXCLUSIONS—Scholarship and fellowship grants—trainee's services. Exclusions allowed resident physicians for amounts received from medical center. Medical center is primarily teaching institution. Residents not required to stay in state after completion of residency training. Work could have been performed without residents. *Reference:* 1973 P-H Fed. ¶8630(5). '54 Code Sec. 117.

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APPENDIX H

Internal Revenue Code of 1954 (26 U.S.C. 1964 ed.):

SEC. 163. INTEREST.

(a) GENERAL RULE.–There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * *

APPENDIX I

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

SEC. 1.163-3 *Deduction for bond discount.*

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. ***

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